

96

ANNUAL REPORT

Talk about
solutions

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THE SPIRIT OF NORTEL

People reaching out to meet the challenge of bringing the world together through communications — all in the spirit of leadership, innovation, dedication, and excellence.

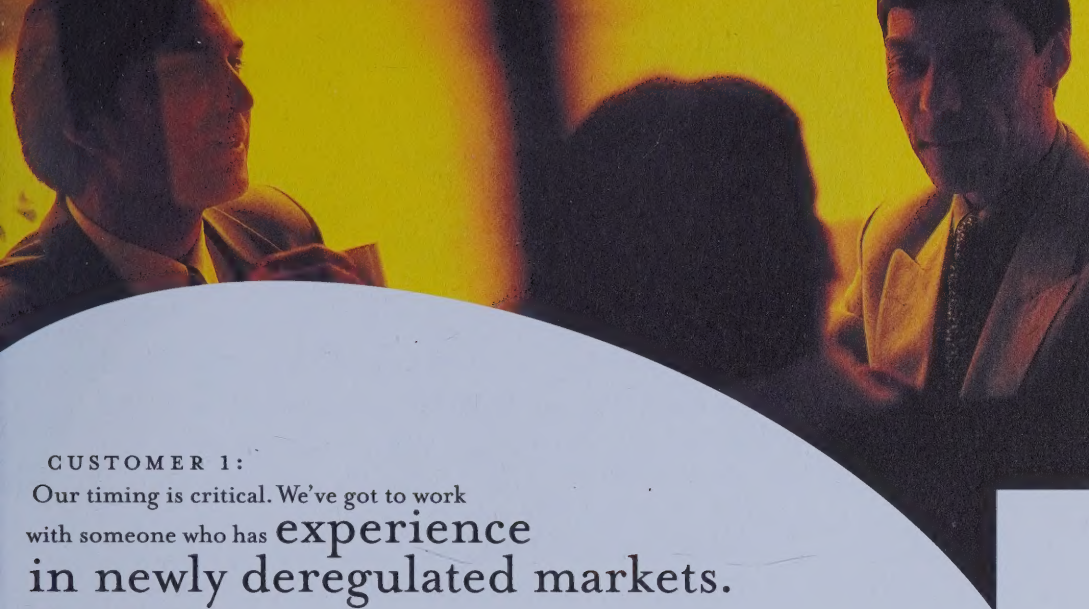
Every four minutes

another network is added to this world. Every four-tenths of a second, another user comes on-line. Nations and businesses around the world are investing heavily to link to the networked global economy. They realize that today's markets belong to the swift, to those who can deliver customer value through unique networking solutions.

1

EXTENDING GLOBAL REACH

Will you be
there for me?



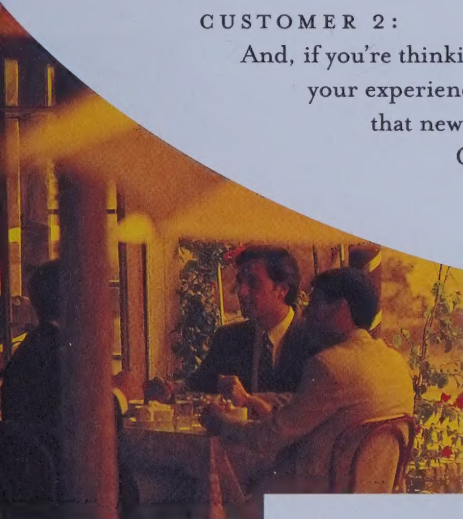
CUSTOMER 1:

Our timing is critical. We've got to work
with someone who has **experience**
in newly deregulated markets.

We just don't have time to learn from
scratch. We want to move fast, you know,
but not so fast we blow it.

CUSTOMER 2:

And, if you're thinking about
your experience with
that new network in Mexico,
Chile's a different story.

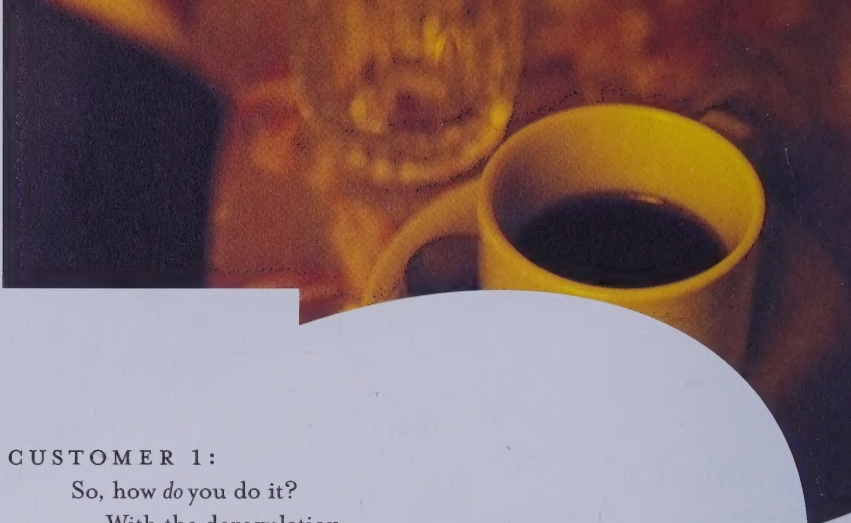


NORTEL:

Taking a network from design to construction to
profitability is different in every market. Getting
a Mexican network up and running in eleven
months is different from getting one going in the
United Kingdom or building a network in Japan.
The common denominator in all markets is
knowing the territory, customizing the solution, and

**sticking around for
the long run.**





CUSTOMER 1:

So, how *do* you do it?

With the deregulation

happening here, **our**

opportunities are huge.

But so are the headaches.

NORTEL:

The first question I'd ask is

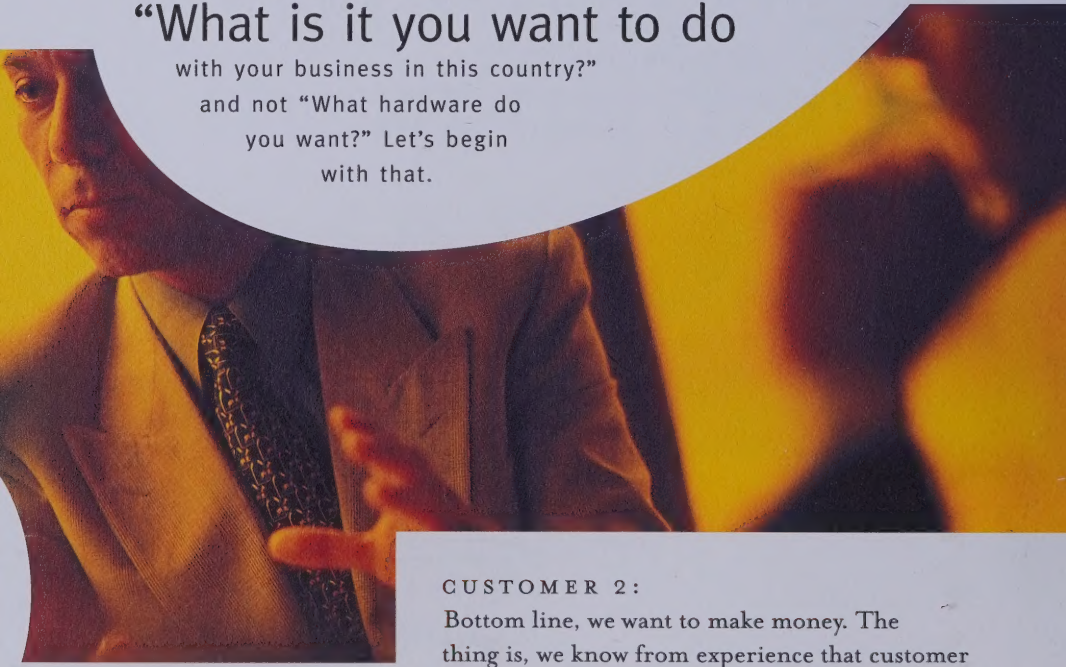
"What is it you want to do

with your business in this country?"

and not "What hardware do

you want?" Let's begin

with that.



CUSTOMER 2:

Bottom line, we want to make money. The

thing is, we know from experience that customer
satisfaction, time to market, deploying

the **services our**
customers really want—

these are the things that lead to profitability. So let's

talk about what your network solutions can deliver right now and
where they can take us down the road...

ONE: EXTENDING GLOBAL REACH

Nortel designs, builds, and integrates digital networks for customers in the information, communication, entertainment, education, and commerce markets. We work with our customers in more than 150 countries and territories around the globe, creating a world of wireless, enterprise, public carrier, and broadband networks.

◦ **IN JUST ELEVEN MONTHS**, Nortel designed, deployed, and ushered into service a high-performance, full-service SDH network solution for Avantel in Mexico. The solution included all switching, transmission, network management, and power systems – all interconnected.

◦ **IN THE UNITED KINGDOM**, Nortel helped Energis create a fiber-optic network using the national electric grid to provide telecommunications, completing the work just eighteen months after Energis gained its public network operator's license.

◦ **NORTEL DELIVERED** an experimental cable telephone system to TV Chigasaki in Japan.

◦ **IN FACT, NORTEL HAS HELPED CREATE** many of the major "second" or competitive networks around the globe, including the three largest competitive long distance networks in North America, and the second and third national networks in the United Kingdom.

◦ **NORTEL DIGITAL WIRELESS NETWORK SOLUTIONS** were selected or placed in service by operators around the world, including: GSM networks for Omnipoint in the United States, Canada's Microcell, Ireland's Esat Digifone, and China's Mandarin Communications; CDMA networks for Sprint PCS in the United States and Canada's BC TEL Mobility; and PROXIMITY fixed wireless access networks for Ionica in the United Kingdom and Telecom Finland.

◦ **NORTEL'S OWN CORPORATE NETWORK** links 250 network locations in a global multimedia environment connecting more than eighty thousand devices and handling around one million e-mail messages a day. We have deployed Nortel's enterprise solution, based on asynchronous transfer mode (ATM) technology, for the North American backbone network, with plans to expand to the European, Latin American, and Asia/Pacific operations. This backbone handles 372,000 call minutes and 74 gigabits of wide area data packets per day. We put our "mission-critical" business services on this network every day, around the clock. And we're helping to build similar networks for other global enterprises around the world.

In short, we are unleashing the full force of the corporation to satisfy customers wherever they are in the world, or wherever they choose to operate.

2

OFFERING A BROAD PORTFOLIO

How do we
make the right
choices?



CUSTOMER 1

That's what this video-conference is for. Our CFO's going to need justification, given the kind of expenditure we're talking about. So I'm going to turn the intensity level up a little bit here, because I'm really feeling the heat. There are plenty of choices out there, and this is probably the most important — and most difficult — decision I've had to make in my career. I'm betting my job and my company's market value on Nortel.



CUSTOMER 2

What we're saying is that change is making our decision particularly difficult. Technology changes every day. I mean, the Internet was leading-edge just a year ago. Today, it's a critical part of our network mix. Same goes for cell phones and voice recognition.

CUSTOMER 1

We talked about being global, how it's become a fact of life. Our customer base has no geographic boundaries. You know the real estate expression that success depends on three things: location, location, and location. Well, that's more true today than ever before.





NORTEL

Right, and location means being in the right place at the right time. And working with someone who's already been there and done the things you need.

CUSTOMER 1

But it's more than location. It's also offering my customers unique services that satisfy their needs as they grow — and set us apart from the competition.

NORTEL

O.K. Let me explain how Nortel's product portfolio can make a difference for you. First we start with the fact that excellent solutions require excellent products. But it's more than just products that make the portfolio significant. Assume that you come to me and say, "I need portability in the workplace — but that portability can't come at the expense of my desk phone." That's a challenge we can overcome because we have a world-class portfolio of enterprise networking products. We offer wireless solutions that meet every global standard. And we have the kind of R&D savvy to adapt and blend those solutions. What you get is a pioneering solution based on proven technologies.





CUSTOMER 2

You say you can blend previously separate network segments to create new and unique solutions?

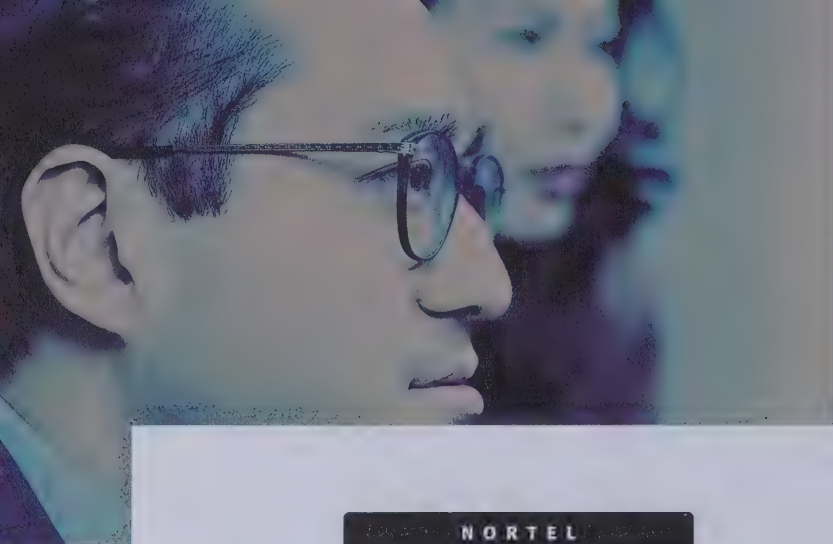
NORTEL

That's precisely what I'm saying. Now, add our global presence to the mix. We have relationships with network providers and enterprises around the world. We know what works no matter where you're doing business. With Nortel, you're gaining access to those relationships.

CUSTOMER 2

That's important, but let's get closer to home. Tell me again about your Internet and CTI differentiation. These are critical areas for us.





Executive Director **NORTEL** President

We've removed Internet traffic congestion and security concerns from the equation. Nortel offers a full Internet/intranet solution set that won't get bogged down, and it's a solution that will grow with you. In a nutshell, we take fear out of conducting business on the web. The result is better services for both you and your customers.

Customer **CUSTOMER 1**

And can you take the complexity out of computer telephony integration?

Executive Director **NORTEL** President

You've described a need that I think can best be satisfied with a voice response system. Let me give you a demonstration. I've put a number up on your video monitor. Dial that number. When you get an answer, just speak the name of any stock you're interested in.

Customer **CUSTOMER 2**

Amazing. I think we're ready to sell this proposal.



TWO: OFFERING A BROAD PORTFOLIO

Variety and choice are central to meeting customers' diverse needs for digital network solutions and services. Our portfolio allows us to create unique solutions that offer lower operating costs, faster service deployment, flexible evolution strategies, and new revenue generation.

- **THE NATIONAL FOOTBALL LEAGUE'S DALLAS COWBOYS** in the United States turned to Nortel for a feature-rich Internet solution.
- **MINNESOTA-BASED DELUXE CORPORATION'S** global enterprise network and Bassett Healthcare's telemedicine network are based on Nortel's ATM technology.
- **MORE THAN 8,100** Nortel Companion wireless business systems are serving customers in more than twenty-five countries worldwide.
- **IBM, HEWLETT-PACKARD, AND THE CANADIAN GOVERNMENT** adopted the Entrust data security and encryption solution.
- **NORTEL IS THE ONLY SUPPLIER** offering a complete portfolio of network solutions around the world in all major digital wireless technologies, including GSM, CDMA, TDMA, and CDPD.
- **NORTEL'S NEW DIGITAL CONTROL CHANNEL** software gave AMPS/TDMA wireless operators access to advanced digital PCS features, and AT&T Wireless Services selected Nortel's COMPANION Microcellular System – with Digital Control Channel – to extend its digital personal communications services (PCS) offering to include enterprise mobility.
- **SOUTHWESTERN BELL** became the first public carrier in the world to deploy Nortel's Internet Thruway, which reduces the cost of handling the explosive growth of Internet traffic while offering new revenue services to service providers and subscribers.
- **ISRAEL'S BEZEQ TELECOMMUNICATIONS CORPORATION** deployed Nortel's ServiceBuilder solution to rapidly create and deploy new services.

No matter how you want your network to evolve, Nortel can take you there.

3

BUILDING DIGITAL NETWORKS

Networks?
I thought Nortel
was a switching
manufacturer.

CUSTOMER:

I suppose by now you're getting used to driving on the left?



NORTEL:

I'm still mostly taking cabs. *It's safer that way...for everyone.*

CUSTOMER: Well, thanks for sharing your taxi. Gives us a chance to catch up before all the trade show chaos begins. I've been reading lately about Nortel's role in designing the Energis and Ionica networks here in the U.K. It wasn't that long ago that Nortel—or Northern Telecom—was synonymous with digital central office switching and PBXs.

NORTEL:

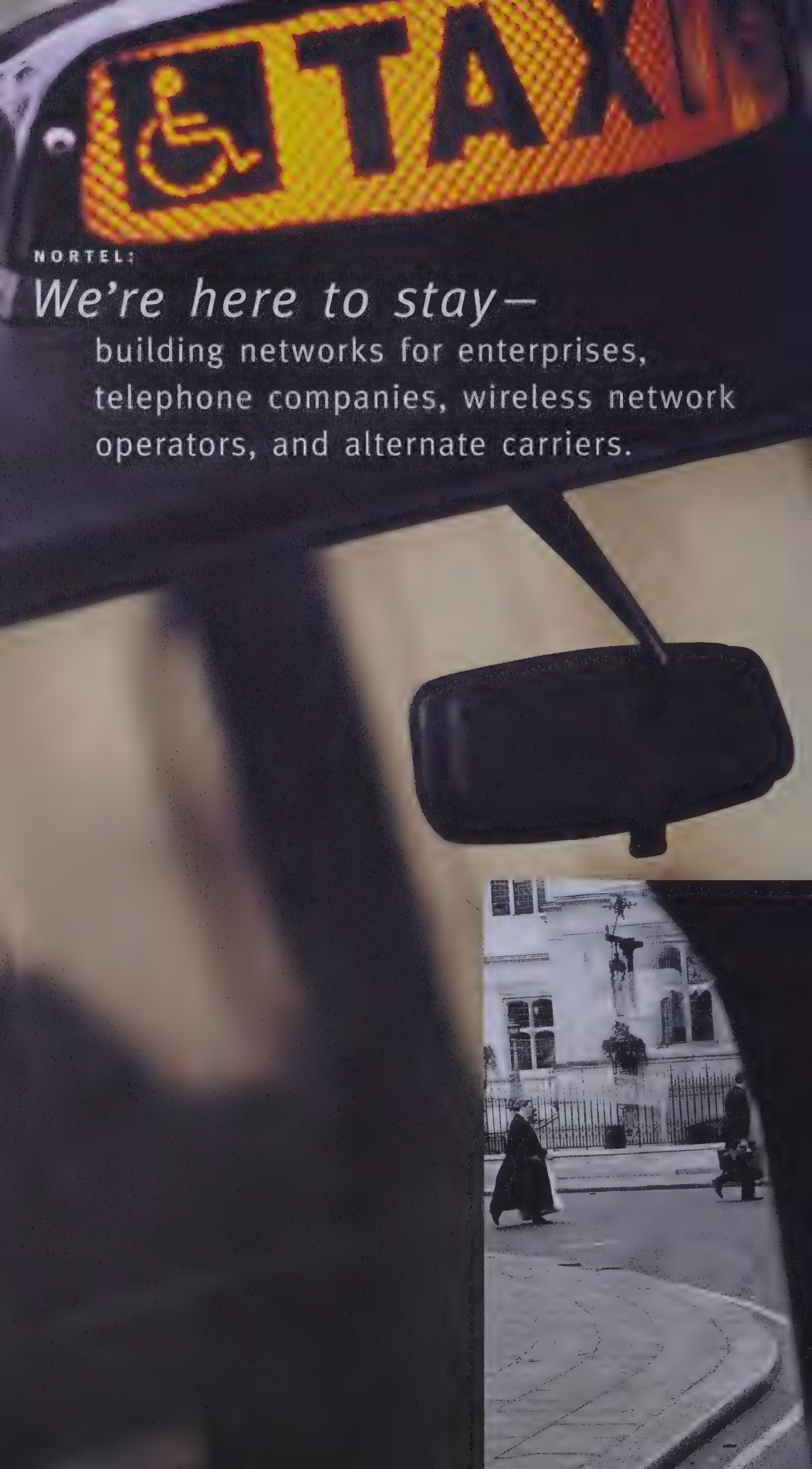
We're still a leader in traditional digital switching solutions. We've simply added new digital solutions to meet the needs of the day.

We no longer think
in terms of switching;
we think networks.

CUSTOMER:

I try to keep up, but it seems you've come out of nowhere and *established a solid presence over here.*





NORTEL:

We're here to stay—

building networks for enterprises,
telephone companies, wireless network
operators, and alternate carriers.





CUSTOMER:

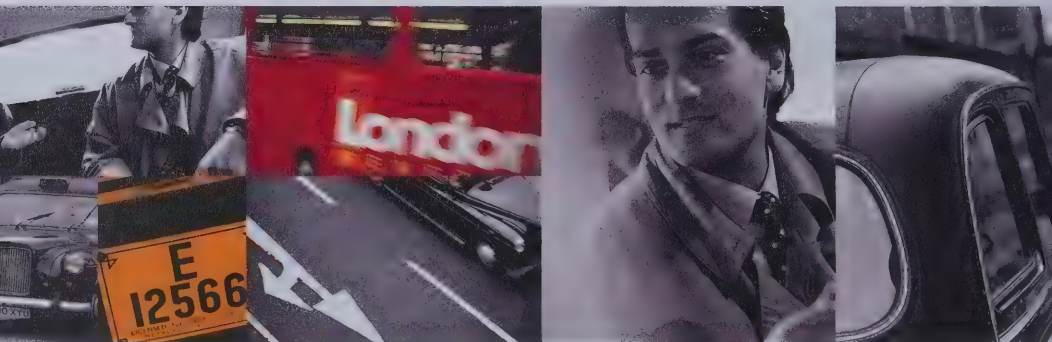
Well, *networks* are the name
of the game... *PCS...*

CUSTOMER:

... it's become pointless to think in terms of separate networks anymore. Or fixed wireless access; yes, it's wireless, but it's also local telephone service. Same goes for ATM switching.

NORTEL:

And it becomes even more intriguing as deregulation heats up. Global carriers have been getting ready with a vengeance, and we are using our broadband ATM solutions to help them compete in what's really a new era of telecommunications. Our R&D people are thriving in this new environment. They're out in the trenches with our customers, *learning what they really need and finding ways to deliver it*. Everything is changing—not just technology, but the marketplace and entire ways of doing business.



CUSTOMER:

I can't think of another time in history where things have moved so fast, or when technology and customers' needs have been so closely meshed. *Having a digital heritage definitely gives you an advantage.*

THREE: BUILDING DIGITAL NETWORKS

Technology convergence is changing the way the world communicates by bringing more intelligence and bandwidth to established and new carrier networks for greater speed to market and service differentiation. It's helping wireless network providers achieve increased mobility, performance, and service functionality. And it's bringing new multimedia applications to enterprises, governments, and other organizations.

◦ **NORTEL IS ONE OF THE WORLD'S LEADING** suppliers of digital switching systems for network operators and for high-capacity synchronous optical transport systems. Nortel leads the market in commercial deployment of 10 gigabits-per-second OC-192 networks, with Nortel OC-192 systems shipped to Touch America, WorldCom, and MCI.

◦ **NORTEL IS A LEADING SUPPLIER** to competitive carriers, including MCI, Sprint, Mercury, Optus, Energis, Avantel, WorldCom, GST, Vyvx, LCI, ICI, Concert, fONOROLA, ICC Communications, and IUSACELL.

◦ **NORTEL CLAIMED AN EARLY LEAD** in the deployment of digital wireless PCS networks in North America. Every one of the first seven 1900 MHz PCS networks in commercial service in the United States uses Nortel digital wireless infrastructure equipment. New Nortel digital wireless PCS networks are in service or under construction in more than fifty cities in North America, with service areas covering more than 160 million potential subscribers.

◦ **ONE OF THE WORLD'S LARGEST** digital wireless networks – CellCom Israel's TDMA network from Nortel – surpassed 500,000 subscribers in its first two years of commercial operation.

◦ **NEW BRUNSWICK TELEPHONE** exploited a Nortel solution to launch the world's first ATM residential broadband network.

◦ **COLOMBIA'S EMTELCO** deployed that country's first ATM integrated services broadband network with a Nortel all-digital solution.

"A World of Networks" is Nortel's vision for the global communications environment: networks serving many different customers, operated by many different entities, and carrying many different kinds of traffic – voice, video, and data – for information, communication, entertainment, education, and commerce.

4

PUTTING IT TOGETHER

What makes you
any different?

Alice, what can I say? Nortel and one other supplier have proposed workable solutions. The technology is close enough, and the pricing is competitive. And since we've been working together a long time, I can be brutally honest with you: There's genuine concern among our management team that Nortel has the brand-name reputation in digital switching, but your expertise in building an integrated, multimedia network is for the most part a mystery to us. Frankly, there's too much money on the table for loyalty to drive this decision. I simply can't make the wrong choice. All things being equal, you need a powerful closing argument. Let me know soon.

--Ben

Ben: First, let me say that all things are NOT equal. A lot of people in this business claim to have a global presence. Others talk about their broad portfolio of products. Some promote their digital networking experience. The fact is, we at Nortel can claim the power of all three. (I've enclosed a file that supports this point.)

te: Fri, 14 Mar 19
om: Alice Franklin
: Ben Smith <bens
hject: Decision fin

--Alice

14 Mar 1998
e-mail
with a bunch of
other time
100. 10

Ben: After my last e-mail, I thought of another important point to share: You also get a sense of **comfort**, because you're not in this alone. You are buying **more than a network**. You're buying Nortel — our people, products, global partnerships, technology, and experience. So at a time when markets are so confusing and chaotic, at least you know you've got **a resource you can count on**.

--Alice

Alice, your summary of what we get when we buy Nortel is just what I need for this afternoon's management discussion, **especially with all the facts to back it up**. Stay close to a phone in case I need to get to you quickly.

--Ben

Ben: You got it. Anything else I can do?

14 Mar 1998
From: Alice
Subject: Summary of
Nortel

Yeah. You guys need to hype your story a little better.

--Ben

FOUR: PUTTING IT TOGETHER

At Nortel, our vision of "A World of Networks" recognizes that customers want more than equipment. They want network solutions that give them competitive advantage in an era of unbridled competition. We believe that Nortel is unique in its ability to provide customers this advantage through a combination of our extensive global presence, broad product portfolio, and digital network leadership.

◦ **APPROXIMATELY 68,000** Nortel employees serve customers around the globe. Sixty-seven percent of regular, full-time employees are knowledge workers. One in four is engaged in technology, primarily in software development.

◦ **NORTEL OPERATES IN MORE THAN 150** countries and territories with thirty-eight research and development sites in sixteen countries and territories.

◦ **SALES OUTSIDE** of North America account for more than 37 percent of total revenues. R&D spending in 1996 totaled approximately \$2 billion dollars.

◦ **NORTEL IS A GLOBAL MARKET SHARE LEADER** in business communication systems, ATM enterprise switching, digital key systems, and call centers.

◦ **SALES OF ENTERPRISE**, wireless, and broadband networks accounted for more than 61 percent of revenues in 1996.

◦ **NORTEL HAS MORE** than 150 million digital access lines in service worldwide.

◦ **OUR BROAD PORTFOLIO** of products enables us to offer customized solutions for enterprises, wireless network providers, local exchange carriers, long distance providers, cable operators, utilities, Internet providers, and alternate network carriers, both large and small, around the world.

In short, Nortel works with customers to deliver total network solutions, including network planning, design, coordination, implementation, and operation.

Nortel=Networks

Network decisions have never been more difficult – or more critical – for our customers. Emerging and converging technologies are mind-numbing. Boundaries are disappearing. Competition is rampant.

It may be the “Age of Choice,” but making those choices is keeping a lot of people awake at night. Nortel helps bring calm amid the chaos.

We are experts in all aspects of networks – data, voice, video, wireless, wired, in any combination – connecting communities, crossing countries, spanning the globe.

Today. Into the future.

LETTER TO SHAREHOLDERS

Our 1996 annual report, titled “Talk about Solutions,” illustrates how Nortel works closely with customers around the world to enable them to create and realize value. Together, we are riding unprecedented waves of change, such as deregulation, technology, and globalization. We believe Nortel is uniquely positioned to help our customers prosper through our combination of network leadership, global presence, and breadth of portfolio. It’s a combination that gives us – and our customers – a powerful advantage as we move to the future together.

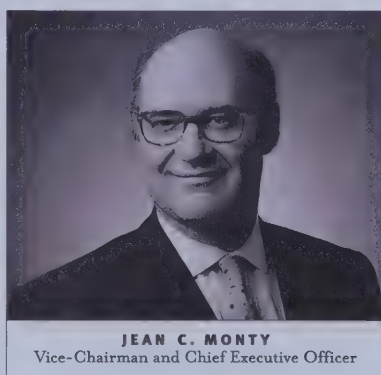
In February 1997, your board announced a succession plan that we feel will assure continuity of the success we have enjoyed in recent years. John A. Roth, chief operating officer since 1995, will succeed Jean C. Monty as president and chief executive officer, effective October 1, 1997. To provide for a smooth transition, Mr. Monty will serve as vice-chairman and continue as CEO of Nortel until October; Mr. Roth will assume the position of president, in addition to continuing as COO. Mr. Monty’s five-year assignment with Nortel ends in October. He will return at that time to BCE Inc., Montréal, in a senior executive position.

By any measure, 1996 was an outstanding year for your company. The results speak for themselves:

- Our 1996 revenues reached a record high: \$12.85 billion, an increase of 20 percent over 1995.
- Net earnings applicable to common shares increased by 32 percent to \$619 million.
- Earnings per common share of \$2.40 for the year were 30 percent higher than in 1995.
- Our order input for 1996 achieved record levels: \$14.08 billion, an increase of 28 percent.
- All network businesses generated revenue growth over 1995, with wireless and broadband networks experiencing substantial increases.

In 1996, we reduced SG&A expenses as a percentage of revenues to 17.1 percent (\$2.20 billion), compared with 18 percent of revenues (\$1.92 billion) in 1995. The increase in absolute dollars reflects our continuing investments in our growing international markets. We are building a global corporation that integrates its operations and rationalizes its engineering, manufacturing, research and development, and marketing resources worldwide.

R&D investments increased to \$1.81 billion in 1996 from \$1.58 billion in 1995, driven primarily by increased investments in the wireless, enterprise, and broadband network portfolios.



JEAN C. MONTY

Vice-Chairman and Chief Executive Officer

LETTER TO SHAREHOLDERS

We are especially pleased with our order backlog of \$6 billion at the end of 1996. Our order backlog is a strong expression of customer confidence that we greatly appreciate. We'll continue to work hard to maintain that confidence as we develop an increasingly diverse base of customers worldwide.

We should also be encouraged by the growth in areas that emphasize our capabilities to provide integrated network solutions to our broad range of customers:

- Wireless networks increased 60 percent, supported largely by the breadth of our wireless portfolio and the emergence of new operators.
- Broadband networks grew 35 percent, driven by the demand for increased bandwidth, or capacity, in carrier networks.
- Enterprise networks increased 19 percent, reflecting increased business communications needs and demand for enterprise connectivity.

These are numbers we're happy to report because they represent an excellent foundation for the future.

Overall, 1996 was a real team effort on the part of the corporation and its employees. We attribute the strong results we achieved to our ongoing commitment to customer satisfaction. For the past five years, our priority — our preoccupation — has been to focus



DONALD J. SCHUENKE
Chairman of the Board

Nortel on significantly improving customer satisfaction by establishing a customer-first mind-set throughout the corporation. This is a "work in progress" driven by three key factors: continuous improvement, creating value for the customer, and employee involvement.

As a Nortel team, we've been working to adopt a passion for satisfying the customer. Customer satisfaction is based on quantifiable and rigorous measurements — determined by our customers, not by Nortel — that provide

us with real-time information on our performance.

We've been communicating to all our colleagues that, to achieve our goals and aspirations, we must have a laser-like focus on delivering value to our customers and on helping them be successful by helping them expand their horizons.

Nortel is fortunate to have good people who are energized and empowered to deliver customer satisfaction through excellence in execution. They understand that quality, innovation, and execution are central to satisfying customers, growing globally, and enhancing shareholder value. Our employees have an energetic and enthusiastic "can do" attitude that's a real competitive advantage. The level of energy and momentum we see in the corporation today is extraordinary.

Our inspiration has its foundation in the Spirit of Nortel: People reaching out to meet the challenge of bringing the world together through communications, all in the spirit of leadership, innovation, dedication, and excellence.

LETTER TO SHAREHOLDERS

The Spirit of Nortel is a motivating force that has withstood the test of time. Developed 25 years ago, it has become the corporation's core ideology, thoroughly integrated into the Nortel way of doing things. It implies an outward-looking company focused on creating something fundamentally new and of great value.

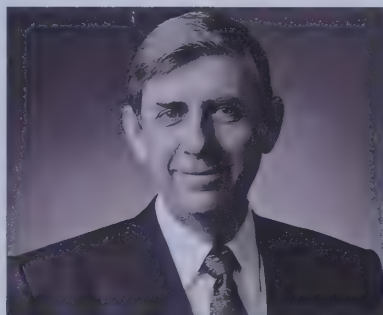
As the millennium approaches, Nortel is in the best industry at the right time. The new golden age of telecom offers Nortel and its customers a world of opportunities on a global scale. Telecommunications has emerged from the background role of a utility to become a prominent provider of applications and network solutions that create new competitive advantages in business, increase productivity in public services, and promote economic development in nations around the world.

We should also remember that new telecom services and applications add value mainly by making people more effective. Investing in telecommunications is not just an investment in technology, it is an investment in enhancing human performance.

At Nortel, we're committed to growing profitably and to both creating and investing in long-term shareholder value. We are, and must remain, a growth company, but that growth must not result from simply striving to be the biggest. Our goal is to be the most *valued* company in the industry. We want Nortel to be a company that is valued by its customers, its employees, its shareholders, and by the communities in which our employees live and work.

Over the past year, we've been very fortunate in the support and commitment we've received from our customers, employees, suppliers, shareholders, and directors. We're grateful for that support and more determined than ever to realize Nortel's vision of being a global company skilled in large-scale, complex network integration. We believe such a company is best fitted for success today and into the future.

Achieving our vision means that our shareholders will not only profit from our success through wealth creation but can also be proud to own part of a valued corporation that contributes to the betterment of society in the 21st century.



JOHN ROTH
President and Chief Operating Officer

A handwritten signature in dark ink, appearing to read 'Jean C. Monty'.

JEAN C. MONTY
Vice-Chairman and
Chief Executive Officer
Northern Telecom Limited
February 27, 1997

A handwritten signature in dark ink, appearing to read 'Donald J. Schuenke'.

DONALD J. SCHUENKE
Chairman of the Board
Northern Telecom Limited

A handwritten signature in dark ink, appearing to read 'John Roth'.

JOHN ROTH
President and
Chief Operating Officer
Northern Telecom Limited

FINANCIAL HIGHLIGHTS

<i>Millions of dollars except per share figures unless otherwise stated</i>	1996	1995	1994
Revenues	\$12,847	\$10,672	\$8,874
Net earnings applicable to common shares	619	469	404
Earnings per common share	2.40	1.85	1.60
Dividends per common share	.50	.42	.36
Common shareholders' equity	4,509	3,798	3,355
Working capital	3,099	2,051*	2,160
Capital expenditures	601	577	389
Research and development expense	1,813	1,579	1,156
Common shares outstanding (as at December 31, in millions)	260	254	253
Average common shares outstanding (in millions)	258	254	252
Common shareholders (as at December 31)	8,891	9,521	10,298
Employees (as at December 31)	67,584†	63,715‡	57,054

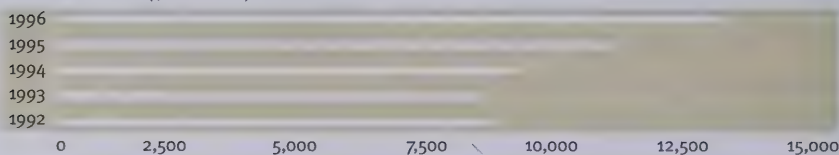
All dollar amounts in this annual report are in U.S. dollars unless otherwise stated.

* Comparative amount has been restated to conform with the current year's presentation.

† Includes Nortel's proportionate share of the employees of all joint ventures.

‡ Includes Nortel's proportionate share of the employees of Matra Communication S.A.S.

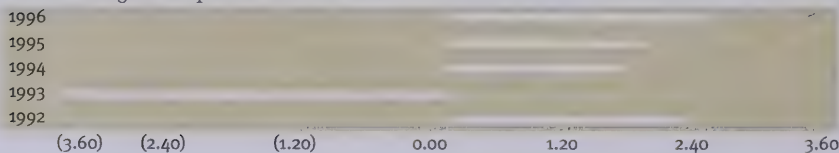
Revenues (\$ millions)



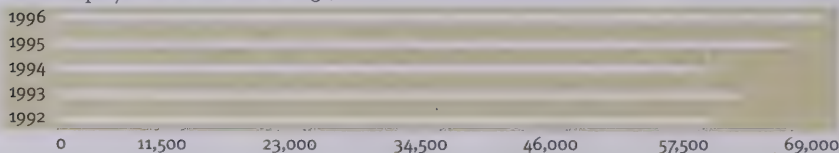
Net earnings (loss) applicable to common shares (\$ millions)



Earnings (loss) per common share (\$)



Employees (as of December 31)



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FINANCIAL REVIEW

The following provides additional analysis as to Nortel's operations and current financial situation. This commentary is supplementary to and should be read in conjunction with the consolidated financial statements which begin on page 42.

RESULTS OF OPERATIONS

Consolidated revenues in 1996 were \$12.85 billion, an increase of 20 percent over revenues of \$10.67 billion in 1995, which were up 20 percent from revenues of \$8.87 billion in 1994. The increase in 1996 revenues was attributable to a net volume increase of approximately 21 percent, partially offset by price reductions of approximately 1 percent. The increase in 1995 revenues was attributable to a net volume increase of approximately 17 percent and the net effect of dispositions and consolidations of approximately 6 percent, partially offset by price reductions of approximately 3 percent. Net earnings applicable to common shares in 1996 were \$619 million (\$2.40 per common share), up from \$469 million (\$1.85 per common share) in 1995, which were up from \$404 million (\$1.60 per common share) in 1994. Net earnings applicable to common shares were calculated after dividends on preferred shares of \$4 million in each year. Net earnings applicable to common shares in 1996 reflected improved operating earnings, partially offset by lower investment and other income – net and increased interest expense. The 1994 results included gains related to the disposition of the optical fiber and fiber cable manufacturing facility in Saskatoon, Saskatchewan, of \$72 million after tax (\$.29 per common share) and the disposition of the connection, protection, and optical fiber management systems businesses of \$28 million after tax (\$.11 per common share).

Effective February 2, 1996, Nortel sold its structured wiring and copper wire and cable business to Cable Design Technologies (CDT) Canada Inc., since renamed NORDX/CDT, Inc. Effective December 30, 1994, Nortel sold its connection, protection, and optical fiber management systems businesses to Siecor Corporation. Effective May 1, 1994, Nortel sold Northern Telecom Finance Corporation, its wholly owned finance subsidiary in the United States, to General Electric Capital Corporation. On February 28, 1994, Nortel completed the sale of its optical fiber and fiber cable manufacturing facility in Saskatoon, Saskatchewan. Effective January 12, 1994, Nortel sold its semiconductor manufacturing facility in San Diego, California, to SGS-THOMSON Microelectronics Inc. Effective January 1, 1994, Nortel sold its STC Submarine Systems business. Effective January 1, 1995, Nortel proportionately consolidated the results of its joint ventures, as required under Canadian generally accepted accounting principles. Prior to January 1, 1995, the joint ventures were accounted for by the equity method. A substantial portion of the amounts proportionately consolidated relate to the operations of Matra Communication S.A.S. (Matra Communication). Earnings per common share were not affected by the proportionate consolidation. The net effect of the dispositions and the proportionate consolidation of all joint ventures was to increase revenues by approximately \$748 million and \$703 million, in 1996 and 1995, respectively.

On July 21, 1993, the Corporation announced \$1.16 billion in special charges for a restructuring program (\$409 million pre-tax), a new software initiative (\$252 million pre-tax), and a goodwill write-down (\$500 million). The final phases of the restructuring program were completed during 1996, with the result that the restructuring and software provisions as at December 31, 1996, were nil and nil, respectively. The restructuring and software provisions were fully utilized. The benefits of the restructuring program began to materialize in the second half of 1994 and continued throughout 1995 and 1996 and were reflected in the results for the second half of 1994 and all of 1995 and 1996, particularly in cost of revenues and selling, general and administrative expense. In 1996, as part of the final phases of the restructuring program, Nortel sold its structured wiring and copper wire and cable business effective February 2, 1996.

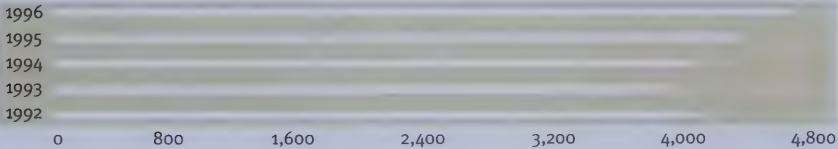
FINANCIAL REVIEW

PRODUCT LINE REVENUES

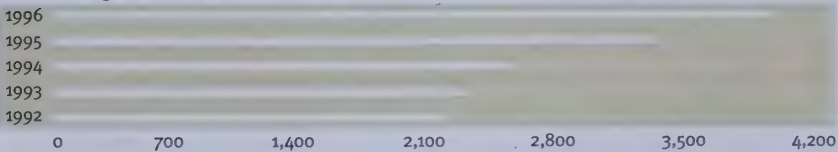
Revenues were up substantially in 1996 compared to 1995, primarily as a result of higher revenues for wireless networks, enterprise networks, broadband networks and switching networks, partially offset by lower other revenues. Revenues were up substantially in 1995 as compared with 1994, primarily as a result of higher revenues for enterprise networks, wireless networks, switching networks, and broadband networks, partially offset by lower other revenues. Software sales decreased in 1996, as compared with 1995 and increased substantially in 1995, as compared with 1994.

Switching networks revenues increased by 7 percent in 1996 to \$4.54 billion (35 percent of total revenues) from \$4.23 billion (40 percent of total) in 1995, which increased by 8 percent from \$3.93 billion (44 percent of total) in 1994. The increase in 1996 was due primarily to a significant increase in the United States, partially offset by a substantial decrease in Caribbean and Latin America (CALA) and a significant decrease in Europe. Switching networks revenues in Asia Pacific and Canada increased significantly. The increase in 1995 was due to substantially higher sales in Europe and CALA, partially offset by substantially lower sales in Asia Pacific and decreased sales in Canada. Switching networks revenues in the United States were essentially flat in 1995 compared with 1994. The higher European switching networks revenues in 1995 were mainly due to the proportionate consolidation of Matra Communication. North American switching revenues continue to be impacted by the shift in capital spending by certain customers away from switching networks to emerging products such as wireless networks, enterprise networks, and broadband networks. At the same time, growth of Internet-driven infrastructure and second lines to the home as well as increased competition among telecommunications operators following the passage of the United States Telecommunications Act of 1996 (the 1996 Act), is leading to higher demand for switching networks products.

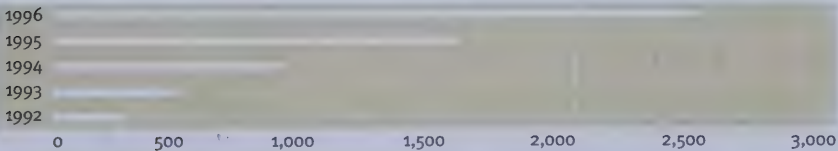
Switching networks revenues (\$ millions)



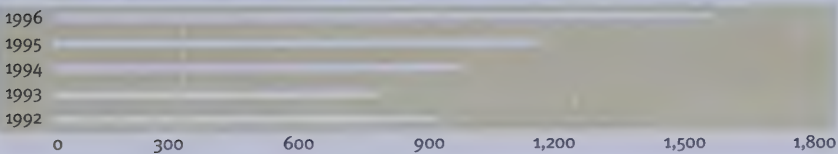
Enterprise networks revenues (\$ millions)



Wireless networks revenues (\$ millions)



Broadband networks revenues (\$ millions)



FINANCIAL REVIEW

Enterprise networks revenues increased by 19 percent in 1996 to \$3.87 billion (30 percent of total revenues), from \$3.25 billion (30 percent of total) in 1995, which was 32 percent higher than \$2.47 billion (28 percent of total) in 1994. The increase in 1996 was primarily due to substantial increases in the United States and significant increases in Europe and Canada. Enterprise networks revenues increased substantially in CALA and increased significantly in Asia Pacific. The increase in 1995 was due to substantially stronger sales in Europe, attributable mainly to the proportionate consolidation of Matra Communication, significantly higher sales in the United States, substantially higher sales in Asia Pacific, and increased sales in Canada, partially offset by slightly lower sales in CALA.

Wireless networks revenues increased by 60 percent to \$2.49 billion (19 percent of total revenues) in 1996 from \$1.55 billion (15 percent of total) in 1995, which increased by 74 percent from \$893 million (10 percent of total) in 1994. The increase in 1996 was due primarily to substantial increases in the United States and Europe. Wireless networks revenues increased substantially in Canada and significantly in Asia Pacific, partially offset by slight declines in CALA. The increase in 1995 was due to substantially stronger sales in Europe, the United States, Asia Pacific, and Canada. Wireless networks revenues in CALA were essentially flat in 1995 compared with 1994. The increase in European wireless networks revenues in 1995 was mainly due to the proportionate consolidation of Matra Communication.

Broadband networks revenues were \$1.51 billion (12 percent of total revenues) in 1996, up 35 percent from \$1.11 billion (10 percent of total) in 1995, which increased 19 percent from \$933 million (11 percent of total) in 1994. The increase in 1996 was primarily due to substantial increases in the United States. Broadband networks revenues increased substantially in CALA, increased significantly in Europe, improved in Asia Pacific and were essentially flat in Canada compared to 1995. The increase in 1995 was a result of substantially higher sales in Asia Pacific, significantly higher sales in the United States, and substantially higher sales in CALA. Broadband networks revenues in Europe and Canada were essentially flat in 1995 compared with 1994.

Other revenues, comprising revenues from miscellaneous other products, interest income of the finance subsidiaries, research and development performed on behalf of customers and, prior to February 2, 1996, cable and outside plant products, were \$446 million (4 percent of total revenues) in 1996, compared with \$529 million (5 percent of total) in 1995 and \$651 million (7 percent of total) in 1994. The decreases in 1996 and 1995 were due primarily to the sales of businesses in 1994 and the disposition of the structured wiring and copper wire and cable business in 1996.

On January 28, 1997, Nortel announced the availability of certain supplemental summary financial information on its portfolio of products that provide networking solutions for the data and multimedia communications market. This market is addressed by products in multiple lines of Nortel's business. Revenues in the data and multimedia communications portfolio of products were \$640 million in 1996, up 59 percent from \$403 million in 1995, which was up 44 percent from \$280 million in 1994.

GEOGRAPHIC REVENUES

Revenues (based on the location of the customer rather than the location of the selling organization) increased in all markets in 1996 compared to 1995, increased in all markets except Canada in 1995 compared to 1994, which was essentially flat. Revenues in 1994 from certain geographic locations were reclassified to conform with the 1995 and 1996 presentation.

FINANCIAL REVIEW

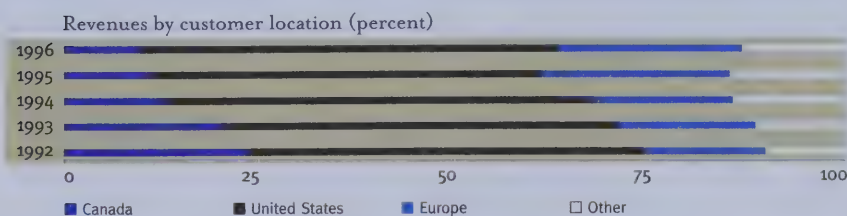
Revenues in the United States were \$6.86 billion (53 percent of total revenues) in 1996, up 28 percent from \$5.35 billion (50 percent of total) in 1995, which was up 10 percent from \$4.85 billion (55 percent of total) in 1994. This increase in 1996 was primarily due to substantially higher sales to wireless operators and interexchange carriers, significantly higher sales to regional holding companies, substantially higher sales to distributors and higher sales to independent telecommunications companies. The increase in 1995 was primarily due to substantially higher sales to wireless operators, significantly higher sales to distributors, higher sales to independent telecommunications companies, significantly higher sales to interexchange carriers, and slightly higher sales to regional holding companies.

The 1996 Act, comprehensive legislation amending the Communications Act of 1934, became law on February 8, 1996. The principal objective of the 1996 Act is to stimulate competition in all segments of the telecommunications industry in the United States. Nortel expects the 1996 Act to have a positive impact on telecommunications equipment suppliers generally. In addition to allowing existing industry participants to enter new businesses, the 1996 Act should also result in new market entrants providing telecommunications services and an expanded market for telecommunications equipment. The United States Federal Communications Commission (the FCC) is in the process of implementing the 1996 Act. Due to pending litigation challenging various aspects of the 1996 Act and the FCC rules designed to implement the 1996 Act, it is difficult to assess with any precision the impact of the 1996 Act on Nortel's overall operations.

Prior to 1996, Nortel's principal competitor in the United States was AT&T Corp. (AT&T). In 1995, AT&T separated into three publicly traded companies, including Lucent Technologies Inc. (Lucent), a manufacturer of telecommunications systems. Upon completion of its initial public offering in April 1996, Lucent became Nortel's principal competitor in the United States. Nortel does not expect that the establishment of Lucent will have a material impact on Nortel's overall operations.

Revenues in Europe (including Africa, the Commonwealth of Independent States, and the Middle East) were \$3.03 billion (24 percent of total revenues) in 1996, up 17 percent from \$2.59 billion (24 percent of total) in 1995, which increased 64 percent from \$1.58 billion (18 percent of total) in 1994. Revenues in Europe were up in 1996 compared with 1995, due to substantially increased sales in wireless networks and significantly increased sales in enterprise networks, partially offset by significantly decreased sales in switching networks. Other revenues in Europe increased substantially and broadband networks revenues increased significantly. Revenues in Europe were up substantially in 1995 compared with 1994 due mainly to the proportionate consolidation of Matra Communication, substantially increased sales of wireless networks and switching networks, significantly increased sales of enterprise networks, and slightly increased sales of broadband networks, partially offset by significantly decreased sales of other products.

Revenues in Canada were \$1.23 billion (10 percent of total revenues) in 1996, up 8 percent when compared to revenues of \$1.14 billion (11 percent of total) in 1995, which were flat when compared to revenues of \$1.14 billion (13 percent of total) in 1994. In 1996,



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sales increased to Bell Canada and other BCE Inc. affiliates, and to other Canadian customers. In 1995, significantly higher sales to Bell Canada and other BCE Inc. affiliates were offset by significantly decreased sales to other Canadian customers.

Revenues in other markets, comprising the Asia Pacific and CALA markets, were \$1.73 billion (13 percent of total revenues) in 1996, up 8 percent from \$1.60 billion (15 percent of total) in 1995, which increased 23 percent from \$1.30 billion (14 percent of total) in 1994. Revenues in Asia Pacific in 1996 increased significantly from 1995 due to significant increases in switching networks, enterprise networks, and wireless networks. Revenues in Asia Pacific in 1995 increased significantly from 1994 primarily due to substantial increases in all product line revenues except switching networks revenues, which decreased substantially. Revenues in CALA in 1996 were essentially flat from 1995, primarily due to substantially decreased sales in switching networks, offset by substantially increased sales in broadband networks and enterprise networks, and a decline in wireless networks revenue and other revenue. Revenues in CALA in 1995 increased substantially from 1994 primarily due to substantial increases in switching networks revenues, wireless networks revenues, and broadband networks revenues, partially offset by substantially decreased sales in other products and slightly decreased sales in enterprise networks.

Revenues (based on the location of the selling organization rather than the location of the customer) increased in all geographic areas in 1996, increased in all geographic areas except Canada in 1995, and increased in all geographic areas except Canada and Europe in 1994. Revenues from the United States were \$7.40 billion (58 percent of total revenues) in 1996, up 27 percent from \$5.81 billion (54 percent of total) in 1995, which was up 7 percent from \$5.44 billion (61 percent of total) in 1994. Revenues from Europe were \$3.00 billion (23 percent of total revenues) in 1996, up 17 percent from \$2.57 billion (24 percent of total) in 1995, which was up 70 percent from \$1.51 billion (17 percent of total) in 1994. Revenues from Canada were \$1.49 billion (12 percent of total revenues) in 1996, up 2 percent from \$1.46 billion (14 percent of total) in 1995, which was down 1 percent from \$1.48 billion (17 percent of total) in 1994. Revenues from other locations were \$956 million (7 percent of total revenues) in 1996, up 15 percent from \$830 million (8 percent of total) in 1995, which was up 83 percent from \$453 million (5 percent of total) in 1994.

GROSS PROFIT

Gross profit in 1996 increased by \$840 million to \$5.13 billion from \$4.29 billion in 1995, which was \$1.02 billion higher than the gross profit of \$3.27 billion in 1994. The gross margin in 1996 was 40.0 percent of revenues compared with 40.2 percent in 1995 and 36.8 percent in 1994.

The 1996 increase in gross profit was primarily the result of increased sales in all product lines except other revenues and improved margins in broadband networks and other products, partially offset by reduced margins in wireless networks, enterprise networks, and switching networks. The 1995 increase in gross profit was primarily the result of increased sales in all product lines except other revenues and improved gross margins in switching networks, enterprise networks, and broadband networks, partially offset by lower gross margins on sales of wireless networks and lower gross margins on Matra Communication sales.

Although competitive pricing pressure continues to exist, Nortel has been able to offset such pressure through the sale of higher margin products and the benefits of the restructuring program. Gross margin is affected by the level of software sales. Gross margin is being negatively impacted by: (i) the introduction of new products and the continued expansion into new markets, particularly in wireless networks; (ii) provisions relating to the sale of

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products and services where such sales are financed by Nortel, particularly in the emerging North American personal communication services (PCS) market and international markets; and (iii) the increased inclusion of products manufactured by other suppliers in network solutions offered by Nortel.

SELLING, GENERAL AND ADMINISTRATIVE (SG&A) EXPENSE

SG&A expense in 1996 of \$2.20 billion (17.1 percent of total revenues) increased by 14 percent from \$1.92 billion (18.0 percent of total) in 1995, which increased by 14 percent from \$1.68 billion (18.9 percent of total) in 1994. This decrease in SG&A as a percentage of revenue in 1996 was a result of successful cost containment efforts and the continued benefits of the restructuring program. The decrease in SG&A as a percentage of revenue in 1995 was a result of cost containment efforts and the benefits of the restructuring program, partially offset by the proportionate consolidation of Matra Communication. The planned absolute dollar increase in SG&A expense for 1996 compared with 1995 reflects the continuing investment in growing international markets in our enterprise networks, wireless networks, and broadband networks businesses.

RESEARCH AND DEVELOPMENT (R&D) EXPENSE

Total R&D expense, which is net of global investment tax credits of \$118 million for 1996, including R&D costs incurred on behalf of others, was \$1.98 billion, \$1.75 billion, and \$1.30 billion for 1996, 1995, and 1994, respectively. Nortel's R&D expense in 1996 was \$1.81 billion (14.1 percent of total revenues), compared with \$1.58 billion (14.8 percent of total) in 1995, and \$1.16 billion (13.0 percent of total) in 1994. The level of investment in all three years reflects ongoing programs across all network businesses for new products, process development, advanced capabilities, and services for a broad array of applications. R&D investment increased in 1996 in all product lines, except switching networks, with the largest increases in wireless networks and enterprise networks. Effective 1994, certain costs, primarily representing product design verification and testing activities, which had been recorded principally as cost of revenues, have been reclassified to R&D expense.

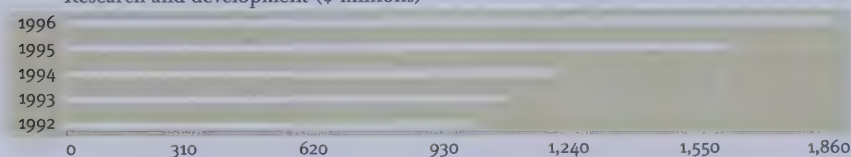
GOODWILL AMORTIZATION

Goodwill amortization charged to operations, including that in equity in net earnings of associated companies, was \$45 million, \$39 million, and \$23 million for 1996, 1995, and 1994, respectively. Goodwill amortization primarily reflects the investment in Matra Communication and STC PLC, and in 1996 also includes the goodwill associated with the acquisition of MICOM Communications Corporation (MICOM).

INVESTMENT AND OTHER INCOME – NET AND INTEREST EXPENSE

Investment and other income – net, including equity in net earnings of associated companies, was \$39 million in 1996, \$114 million in 1995, and \$217 million in 1994. The decrease in 1996 was primarily a result of substantially higher foreign exchange losses as compared to 1995, substantially lower interest income earned in 1996 due to lower average cash balances than in 1995, and lower equity earnings of associated companies, partially

Research and development (\$ millions)



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offset by the gain on the sale of common shares of Entrust Technologies Inc. (Entrust). In December 1996, Nortel formed Entrust to carry on the business of the secure networks business unit of enterprise networks and provide public key infrastructure software products for the encryption and digital signature of information communicated between client workstations over the Internet and intranets. On December 31, 1996, Entrust issued 260,000 Series B Common Shares for total cash consideration of \$26 million which reduced Nortel's ownership in Entrust to 72.9 percent. As a result of the transaction, Nortel recorded a gain on reduction in ownership of subsidiary stock of \$19 million (\$.07 per common share). The decrease in 1995 from 1994 was primarily a result of an insignificant foreign exchange loss in 1995, as compared with substantial foreign exchange gains resulting from the consolidation of Netaş-Northern Electric Telekomünikasyon A.S. (Netaş) in 1994. Significantly higher interest income earned in 1995 on cash balances resulting from the proceeds of disposals of businesses in 1994, and the favorable 1994 operating cash flow performance was offset by substantially lower equity earnings of associated companies.

Nortel continues to expand its business globally and, as such, an increasing proportion of its business will be derived from countries outside of the United States and Canada. As a result, fluctuations in foreign currencies may have an impact on Nortel's business and financial results. Nortel endeavours to minimize the impact of such currency fluctuations through its ongoing commercial practices and by attempting to hedge its exposures to such currencies. In attempting to manage this foreign exchange risk, Nortel identifies operations and transactions that may have foreign exchange exposure, based upon, among other factors, the excess or deficiency of foreign currency receipts over foreign currency expenditures in each of Nortel's significant foreign currencies. Nortel's significant currency flows in 1996 and 1995 were in United States dollars, Canadian dollars, United Kingdom pounds, and French francs. In 1996, the net impact of foreign exchange fluctuations was a loss of \$44 million, primarily due to the strengthening of United Kingdom pounds in relation to United States dollars, as compared to an insignificant net impact in 1995.

Interest expense was \$175 million in 1996, \$160 million in 1995, and \$188 million in 1994. The increased interest expense for 1996 was primarily a result of the increased use of commercial paper to fund cash requirements. The reduced interest expense for 1995 was primarily a result of repayment of debt owed by Netaş and the repayment of corporate debt in 1994, partially offset by the effect of proportionately consolidating Matra Communication, an increased interest rate (set biannually) pursuant to an existing interest rate agreement, and the increased use of commercial paper to fund cash requirements.

INCOME TAXES

The provision for income taxes was \$321 million in 1996, compared with a provision of \$233 million in 1995, and \$161 million in 1994 (with effective rates of 34.0, 33.0, and 28.4 percent, respectively). The increase in the 1996 tax rate was due to the change in geographic earnings mix. The increase in the 1995 tax rate was due to the change in geographic earnings mix and reflects the effect in 1994 of lower rates of income tax expense on the gains related to the sale of the optical fiber and fiber cable manufacturing facility and the sale of the connection, protection, and optical fiber management systems businesses. The income tax expense on operating earnings for 1994 was 29.9 percent.

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ORDER BACKLOG

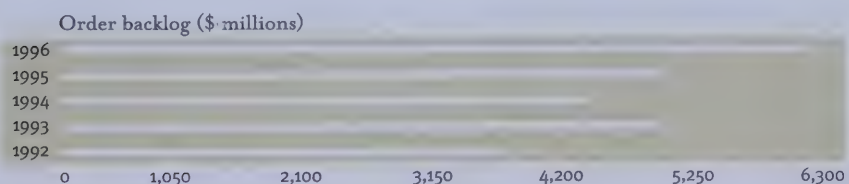
Order backlog at December 31, 1996, was \$6.03 billion, up 25 percent from the \$4.82 billion of orders on hand at December 31, 1995, which was up 14 percent from the \$4.24 billion of orders on hand at December 31, 1994. The increase in 1996 was due to substantial increases in wireless networks. The majority of the backlog is scheduled for delivery within twelve months. The increase in 1995 was due to the proportionate consolidation of Matra Communication in 1995 and increases in CALA and other international markets.

LIQUIDITY AND CAPITAL RESOURCES

Cash and short-term investments of \$730 million at December 31, 1996, increased by \$528 million, compared with \$202 million at December 31, 1995. Cash provided by operating activities in 1996 amounted to \$938 million, compared with cash used by operating activities of \$223 million in 1995. Nortel continues to focus on working capital as a key component of cash management. Capital expenditures amounted to \$601 million for 1996, an increase of \$24 million from 1995 capital expenditures of \$577 million. Nortel expects its consolidated capital expenditures for total year 1997 to be substantially above 1996 levels. Acquisitions of \$197 million in 1996, an increase of \$157 million from 1995, was primarily related to the acquisition of MICOM in June 1996. Net proceeds on sales of businesses were \$113 million in 1996, primarily related to the disposition of the structured wiring and copper wire and cable business.

The total debt to total capitalization ratio was 26 percent at December 31, 1996, compared with 29 percent at December 31, 1995, and 29 percent at December 31, 1994.

On November 26, 1996, the Corporation issued C\$400 million Cumulative Redeemable Class A Preferred Shares Series 5 (the Series 5 Shares). The 16 million Series 5 Shares, priced at C\$25 each, will, until December 1, 2001, pay an annual fixed cumulative preferential cash dividend of C\$1.275 per share (5.1 percent), payable, if declared, quarterly. On May 2, 1996, a registration statement of the Corporation and Northern Telecom Capital Corporation (NTCC), an indirect wholly owned finance subsidiary of the Corporation, filed with the United States Securities and Exchange Commission, became effective for \$500 million of debt securities and warrants to purchase debt securities, to be offered by either the Corporation or NTCC, with the payment of any debt securities offered by NTCC guaranteed by the Corporation. This registration statement was in addition to the \$500 million of debt securities and warrants to purchase debt securities remaining available to the Corporation under a separate United States registration statement. On June 17, 1996, NTCC issued \$150 million aggregate principal amount of 7.40 percent Notes Due 2006 and \$150 million aggregate principal amount of 7.875 percent Notes Due 2026, with payment of principal of, and premium, if any, and interest on, such Notes guaranteed by the Corporation. Approximately \$150 million of the proceeds received from the issuance of such notes was used to replenish cash deposits utilized in the acquisition of MICOM. The Corporation has also filed with the securities regulatory authorities in each of the provinces of Canada a short form shelf prospectus to issue up to C\$500 million of debt securities and warrants to purchase debt securities of the Corporation under a Canadian shelf program.



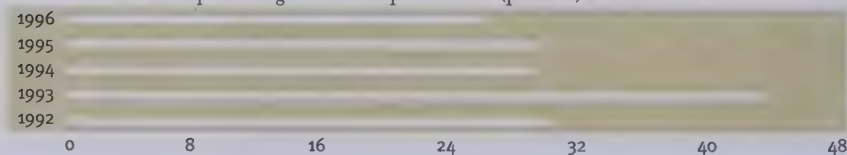
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On April 26, 1995, Nortel entered into five-year and 364-day syndicated credit agreements to permit borrowings in an aggregate amount not to exceed \$1.5 billion, of which \$1.0 billion relates to the five-year agreements and \$500 million relates to the 364-day agreements. On April 23, 1996, Nortel amended the five-year and the 364-day syndicated credit agreements to, among other things, extend the agreements for an additional one year and 364 days, respectively. The entire amount of these committed facilities remains available. Nortel expects to meet its cash requirements from operations and conventional sources of external financing.

The Corporation has initiated a normal course issuer bid to repurchase common shares. This share repurchase program will enable the Corporation to buy back up to 4 million (approximately 1.5 percent) of its common shares (the Shares) in the period from January 30, 1997 to January 29, 1998. Shares will be bought on the Toronto and Montréal stock exchanges at market prices. Shares may be repurchased by the Corporation to offset issuances of new Shares under employee and shareholder plans in order to maintain the approximate number of Shares outstanding, or when such purchases would represent an appropriate use of corporate funds. No special arrangements will be made with particular shareholders to repurchase their Shares. As of February 28, 1997, 836,900 Shares have been repurchased and canceled by the Corporation.

The competitive environment in which Nortel operates increasingly requires Nortel and many of its principal competitors to provide significant amounts of long-term customer financing in connection with the sale of products and services, particularly in the emerging North American PCS market and international markets. While Nortel has generally been able to place its customer financing with third party lenders, Nortel anticipates that, due to the increasing amount of financing it expects to provide and the higher risks typically associated with such financings (particularly where provided to start-up operations or to customers in developing countries), the amount of such financings required to be supported directly by Nortel for at least the initial portion of their term will increase significantly in the future. At December 31, 1996, Nortel had entered into certain financing agreements for the future provision of up to approximately \$2.1 billion of customer financing and had outstanding offers or commitments, subject to fulfillment of certain conditions, to provide up to approximately \$840 million of additional customer financings (not all of which offers or commitments are expected to be taken up). In particular, Nortel has agreed and expects, subject to the fulfillment of certain conditions, to provide up to approximately \$1.3 billion principal amount of financing to Sprint Spectrum L.P. (Sprint Spectrum), a limited partnership formed by Sprint Corporation, Tele-Communications, Inc., Comcast Corporation and Cox Communications Inc., in connection with Sprint Spectrum's purchases of PCS products and related services from or through Nortel. Nortel has obtained a related commitment from QUALCOMM Incorporated (QUALCOMM), to finance certain of the products that are to be sold to Nortel by QUALCOMM for resale to Sprint Spectrum and expects to receive at least \$200 million of such financing from QUALCOMM on terms substantially similar to those offered by Nortel to Sprint Spectrum. On December 10, 1996,

Total debt as a percentage of total capitalization (percent)



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Nortel announced that it was syndicating through a group of major financial institutions approximately \$1.1 billion of such financing. The syndication of participation rights and loan assignments is expected to be completed in early 1997. Nortel expects to continue to arrange for third parties to assume customer financing obligations agreed to by Nortel and to fund other customer financings directly supported by Nortel from working capital and conventional sources of external financing in the normal course.

Nortel has entered into supply contracts with customers for products and services, which in some cases involve new technologies currently being developed or which have not yet been commercially deployed by Nortel or require Nortel to build and operate networks on a "turnkey" basis. These supply contracts may contain delivery and installation timetables and performance criteria which, if not met, could result in Nortel paying substantial penalties or liquidated damages, the termination of the related supply contract, and/or lower shared revenues under a turnkey arrangement.

Effective February 2, 1996, Nortel sold its structured wiring and copper wire and cable business to Cable Design Technologies (CDT) Canada Inc., since renamed NORDX/CDT, Inc., for gross proceeds, before closing adjustments of \$90 million, resulting in no material gain or loss. This transaction is consistent with Nortel's decision to focus its resources on its core product lines.

In June 1994, Nortel and Lagardère SCA (Lagardère) signed an agreement pursuant to which Nortel and Lagardère each hold, directly or indirectly, 50 percent of Matra Communication. In a related agreement, Lagardère may, under specific circumstances, require Nortel to purchase all or part of its equity participation in Matra Communication at a formula price, currently estimated at approximately 1.8 billion French francs (approximately \$335 million) for all its equity participation, with consideration consisting of a long-term interest-bearing note.

LEGAL PROCEEDINGS

In June 1993, certain holders of the Corporation's securities commenced three class actions in the United States District Court for the Southern District of New York alleging that the Corporation and certain of its officers violated the Securities Exchange Act of 1934 and common law by making material misstatements of, or omitting to state, material facts relating to the business operations and prospects and financial condition of the Corporation. Compensatory and punitive damages are sought in each of the class actions. On July 30, 1993, all three actions were consolidated before a judge of the United States District Court for the Southern District of New York. A Consolidated Amended Complaint was filed by all of the plaintiffs on September 16, 1993. On January 21, 1994, a judge of the United States District Court for the Southern District of New York dismissed the purported class actions without prejudice and allowed the plaintiffs to file a Second Consolidated Amended Complaint by February 25, 1994. On February 18, 1994, the plaintiffs filed the Second Consolidated Amended Complaint. The Corporation and the named officers filed a motion challenging the sufficiency of the Second Consolidated Amended Complaint, which was denied in part and granted in part on August 19, 1994. On September 22, 1994, the Corporation and the named officers filed an Answer to the Second Consolidated Amended Complaint. On February 24, 1995, a judge of the United States District Court for the Southern District of New York issued an order certifying the consolidated action as a class action. On April 10, 1996, a Stipulation and Order of Dismissal dismissing one of the named officers as a defendant in the consolidated class action was approved by a judge of the United States District Court for the Southern District of New York. On May 2, 1996,

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the plaintiffs filed a motion to file a Third Consolidated Amended Complaint. The Corporation and the named officers have opposed the amendment and have also filed a motion challenging the sufficiency of the remaining allegations in the Second Consolidated Amended Complaint. The Corporation and the named officers will vigorously defend the consolidated action. At this stage of the consolidated action, the Corporation cannot determine whether the consolidated action will have a material adverse impact on the consolidated financial position or results of operations of the Corporation.

Northern Telecom Inc. (NTI), the Corporation's principal United States subsidiary, received a statutory notice of proposed assessment from the Internal Revenue Service (IRS) dated November 6, 1996, with respect to its 1980 through 1985 federal income tax returns. The notice proposes an additional tax liability of approximately \$524 million, excluding interest at the applicable statutory rates. The notice states that appropriate adjustments have not been made which would reduce the proposed additional tax liability. On February 3, 1997, NTI filed a petition with the United States Tax Court opposing such proposed additional tax liability. The majority of the proposed additional tax liability involves the timing of income recognition and consequently, if the IRS were to prevail, NTI would be entitled to a refund for later taxable years. After consultation with outside tax counsel and the Corporation's independent accountants, it is management's opinion that additional tax liability, if any, resulting from the proposed income tax adjustments will not have a material adverse impact on the consolidated financial position or results of operations of the Corporation.

ENVIRONMENTAL MATTERS

Nortel, primarily as a result of its manufacturing operations, is subject to numerous environmental laws and regulations and is exposed to liabilities and compliance costs arising from its past and current generation, management, and disposition of hazardous substances and wastes.

At December 31, 1996, the accruals on the Corporation's consolidated balance sheet for environmental matters, including those referred to below, were \$50 million. It is anticipated that a majority of the accruals will be spent over the next three years. Based on information presently available, management believes that the existing accruals are sufficient to satisfy probable and reasonably estimable environmental liabilities related to known environmental matters. Any additional liability that may result from these matters, and any additional liabilities that may result in connection with other sites currently under investigation, are not expected to have a material adverse impact on the consolidated financial position or results of operations of the Corporation.

Nortel has remedial activities under way at nine manufacturing sites and seven previously occupied sites. An estimate of Nortel's anticipated remediation costs associated with all such sites, to the extent probable and reasonably estimable, is included in the environmental accruals referred to above in an approximate amount of \$48 million.

Moreover, Nortel has been named as a potentially responsible party (PRP) under the U.S. Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) at six Superfund sites in the United States and is listed as a *de minimis* PRP at three of these Superfund sites. An estimate of Nortel's share of the anticipated remediation costs associated with such Superfund sites is included in the environmental accruals referred to above.

FINANCIAL REVIEW

Liability under CERCLA may be imposed on a joint and several basis, without regard to the extent of Nortel's involvement. In addition, the accuracy of Nortel's estimate of environmental liability is affected by several uncertainties such as additional requirements that may be identified in connection with remedial activities, the complexity and evolution of environmental laws and regulations, and the identification of presently unknown remediation sites. Consequently, Nortel's liability could be greater than its current estimate.

PENSIONS

Nortel has non-contributory defined benefit pension plans covering substantially all of its employees. The benefits are based on length of service and rates of compensation. In determining its pension obligations and expense, the weighted average discount rate used for 1996 pension calculations was 8.3 percent which reflects economies with higher long-term discount rates than would typically be found in the United States. Nortel believes that a downward adjustment of the discount rate may have a material effect on earnings.

RECENT PRONOUNCEMENTS

In June 1996, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (FAS 125). FAS 125 provides consistent standards for distinguishing transfers of financial assets which are sales from transfers that are secured borrowings. FAS 125 is effective for transfers and servicing of financial assets and extinguishment of liabilities occurring after December 31, 1996. The adoption of FAS 125 is not expected to have a material impact on the consolidated financial position or results of operations of the Corporation.

FINANCIAL REVIEW

DIVIDENDS

The Corporation declared and paid a cash dividend of \$.11 per common share in the first quarter of 1996 and \$.13 per common share in each of the three following quarters of 1996, for a total dividend of \$.50 per common share for the year. Total dividends paid on common shares were \$129 million in 1996 and \$107 million in 1995. The Corporation intends to continue paying quarterly dividends on its common shares. The board of directors determines dividend payments based on such considerations as earnings from operations, cash flow, capital requirements, and Nortel's financial condition.

Dividends paid to owners of the Corporation's common shares who are not residents of Canada are subject generally to a 25 percent withholding tax, unless reduced by treaty. Under income tax conventions between Canada and both the United States and the United Kingdom, a withholding tax of 15 percent generally applies to residents of the United States and United Kingdom who do not have a "permanent establishment" or "fixed base" in Canada with which the dividends are effectively connected. Persons subject to either United States or United Kingdom income tax on dividends generally will be entitled, subject to certain limitations, to either a credit or deduction with respect to the Canadian taxes withheld.

Gains on disposals of common shares of the Corporation by owners who are not residents of Canada are generally not subject to Canadian income tax, unless shares are used or held by a non-resident who is carrying on a business in Canada.

STOCK PRICES

The following table shows the high, low, and last (closing) prices of the Corporation's common shares as reported on The Toronto Stock Exchange (TSE) and on the New York Stock Exchange (NYSE) composite tape for each quarter of 1995 and 1996. On January 31, 1997, the last price on the TSE was C\$99¼ and on the NYSE was \$73⅝.

	TSE (C\$)			NYSE composite tape (US\$)		
	High	Low	Close	High	Low	Close
1996						
1st quarter	69¾	55⅝	64⅞	50⅞	40¾	47¾
2nd quarter	75½	63⅝	74¼	55⅝	46⅞	54⅝
3rd quarter	80½	62	78½	58⅞	45	57¾
4th quarter	90	77	85½	67⅝	56⅝	61⅞
1995						
1st quarter	56	45½	53	40	32¼	37⅞
2nd quarter	56	47⅝	49¾	41	35⅝	36½
3rd quarter	52½	46⅝	47¾	39	34½	35⅝
4th quarter	60½	43⅝	58⅝	44¼	31½	43

On December 31, 1996, BCE Inc. owned 51.65 percent of the outstanding common shares of the Corporation, with approximately 8,890 other registered shareholders owning the remaining 48.35 percent.

FINANCIAL REVIEW

TOTAL TAXES PAID

In 1996, Nortel made the following total net cash tax payments:

<i>(millions of U.S. dollars)</i>	1996
Income taxes	\$251
Payroll, sales, property, and other taxes	412
Total	\$663
Total taxes by geographic area:	
Canada	\$106
United States and other	557
Total	\$663

MANAGEMENT'S REPORT

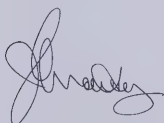
The accompanying consolidated financial statements of Northern Telecom Limited and all information in this annual report are the responsibility of management and have been approved by the board of directors.

The financial statements have been prepared by management in conformity with generally accepted accounting principles in Canada. The financial statements include some amounts that are based on best estimates and judgments. Financial information used elsewhere in the annual report is consistent with that in the financial statements.

Management of the corporation, in furtherance of the integrity and objectivity of the financial statements, has developed and maintains a system of internal controls and supports an extensive program of internal audits. Management believes the internal controls provide reasonable assurance that financial records are reliable and form a proper basis for the preparation of financial statements, and that assets are properly accounted for and safeguarded. The internal control process includes management's communication to employees of policies which govern ethical business conduct.

The board of directors carries out its responsibility for the financial statements in this annual report principally through its audit committee, consisting solely of outside directors. The audit committee reviews the corporation's annual consolidated financial statements and recommends their approval by the board of directors. The shareholders' auditors have full access to the audit committee, with and without management's being present.

These financial statements have been examined by the shareholders' auditors, Deloitte & Touche, Chartered Accountants, and their report follows.



JEAN C. MONTY

President

and Chief Executive Officer



PETER W. CURRIE

Senior Vice-President

and Chief Financial Officer

AUDITORS' REPORT

To The Shareholders

Northern Telecom Limited

We have audited the consolidated balance sheets of Northern Telecom Limited as at December 31, 1996 and 1995 and the consolidated statements of operations, retained earnings and cash flows for each of the three years in the period ended December 31, 1996. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in Canada. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Corporation as at December 31, 1996 and 1995 and the results of its operations and its cash flows for each of the three years in the period ended December 31, 1996 in accordance with accounting principles generally accepted in Canada.



DELOITTE & TOUCHE

Chartered Accountants

Toronto, Canada

February 3, 1997

CONSOLIDATED STATEMENTS OF OPERATIONS

Northern Telecom Limited, year ended December 31 (millions of U.S. dollars except per share figures)

	1996	1995	1994
Revenues	\$12,847	\$10,672	\$8,874
Cost of revenues	7,714	6,379	5,605
Gross profit	5,133	4,293	3,269
Selling, general and administrative expense	2,195	1,923	1,681
Research and development expense (note 2)	1,813	1,579	1,156
Goodwill amortization (note 3)	45	39	23
Operating earnings	1,080	752	409
Equity in net earnings of associated companies	(8)	7	17
Investment and other income – net (note 4)	47	107	200
Interest expense			
Long-term debt	(122)	(126)	(126)
Other	(53)	(34)	(62)
Gain on sales of businesses (note 5)	—	—	131
Earnings before income taxes	944	706	569
Income tax provision (note 6)	321	233	161
Net earnings	623	473	408
Dividends on preferred shares	4	4	4
Net earnings applicable to common shares	\$ 619	\$ 469	\$ 404
Earnings per common share	\$ 2.40	\$ 1.85	\$ 1.60
Dividends declared per common share	\$.50	\$.42	\$.36
Weighted average number of common shares outstanding (millions)	258	254	252

CONSOLIDATED STATEMENTS OF RETAINED EARNINGS

Northern Telecom Limited, year ended December 31 (millions of U.S. dollars)

	1996	1995	1994
Balance at beginning of year	\$ 2,800	\$ 2,438	\$2,125
Net earnings	623	473	408
	3,423	2,911	2,533
Dividends			
Preferred shares	(4)	(4)	(4)
Common shares	(129)	(107)	(91)
Balance at end of year	\$ 3,290	\$ 2,800	\$2,438

CONSOLIDATED BALANCE SHEETS

Northern Telecom Limited, as at December 31 (millions of U.S. dollars)

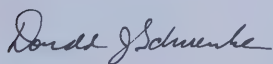
	1996	1995
Assets		
Current assets		
Cash and short-term investments at cost (approximates market value)	\$ 730	\$ 202
Accounts receivable		
Related parties	233	245
Trade (less provision for uncollectibles – \$66 for 1996, \$81 for 1995)	3,858	3,448
Inventories (note 8)	1,679	1,643
Prepaid expenses	94	83
Deferred income taxes	276	201
	6,870	5,822
Long-term receivables (less provision for uncollectibles – \$18 for 1996, \$14 for 1995)	527	414
Investments		
Associated companies at equity	22	22
Other	180	165
	202	187
Plant and equipment – net (note 9)	2,035	1,923
Goodwill	942	847
Other assets	327	287
Total assets	\$10,903	\$9,480

CONSOLIDATED BALANCE SHEETS

Northern Telecom Limited, as at December 31 (millions of U.S. dollars)

	1996	1995
Liabilities and Shareholders' Equity		
Current liabilities		
Notes payable	\$ 95	\$ 180
Accounts payable and accrued liabilities		
Trade and other payables	1,161	1,097
Related parties	26	31
Payroll	252	178
Other accrued liabilities (note 10)	2,110	1,892
Income taxes payable	122	57
Long-term debt due within one year (note 12)	5	336
	3,771	3,771
Long-term liabilities		
Deferred income	20	17
Long-term debt (note 12)	1,663	1,221
Deferred income taxes	97	155
Other liabilities	350	316
	5,901	5,480
Minority interest in subsidiary companies	126	129
Commitments and contingencies (notes 13 and 14)		
Shareholders' equity		
Preferred shares (note 15)	367	73
Common shares (notes 16 and 17)	1,461	1,273
Retained earnings	3,290	2,800
Currency translation adjustment (note 18)	(242)	(275)
	4,876	3,871
Total liabilities and shareholders' equity	\$10,903	\$9,480

On behalf of the Board of Directors



DONALD J. SCHUENKE
Director



L. YVES FORTIER
Director

CONSOLIDATED STATEMENTS OF CASH FLOWS

Northern Telecom Limited, year ended December 31 (millions of U.S. dollars)

	1996	1995	1994
Cash and short-term investments at beginning of year	\$ 202	\$ 1,059	\$ 138
Operating activities			
Net earnings	623	473	408
Items not involving cash			
Depreciation and amortization	525	503	461
Equity in net earnings of associated companies in excess of dividends received	8	(2)	(15)
Decrease in deferred income taxes	(50)	(81)	(42)
Increase (decrease) in other liabilities	(8)	(31)	38
Gain on sales of businesses – net of income taxes	–	–	(100)
Other	(62)	(20)	8
(Increase) decrease in non-cash working capital components (note 19)	(98)	(1,065)	118
Total	938	(223)	876
Investing activities			
Expenditures for plant and equipment	(601)	(577)	(389)
Disposals of plant and equipment	38	16	10
(Increase) decrease in long-term receivables	(132)	(33)	46
Acquisitions and other investments (note 20)	(197)	(40)	(127)
Proceeds on sales of businesses (note 5)	113	4	1,643
Total	(779)	(630)	1,183
Financing activities			
Dividends on common and preferred shares	(133)	(111)	(95)
Increase (decrease) in notes payable	(83)	74	(796)
Additions to long-term debt	457	19	–
Reductions of long-term debt	(354)	(14)	(309)
Issue of preferred shares (note 15)	294	–	–
Issue of common shares (note 16)	188	28	62
Total	369	(4)	(1,138)
Cash and short-term investments at end of year	\$ 730	\$ 202	\$ 1,059
Increase (decrease) in cash and short-term investments	\$ 528	\$ (857)	\$ 921

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Northern Telecom Limited (millions of U.S. dollars except per share figures and unless otherwise stated)

1. SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in Canada. With respect to the consolidated financial statements of Northern Telecom Limited (the Corporation) and its subsidiary companies (collectively, Nortel), there are no material differences between Canadian and United States generally accepted accounting principles (GAAP) except as described in note 7. The Corporation and other Nortel operations domiciled in Canada measure their operations in Canadian dollars and translate to U.S. dollars for reporting purposes.

(A) PRINCIPLES OF CONSOLIDATION

The financial statements of entities which are controlled by the Corporation, referred to as subsidiaries, are consolidated; entities which are jointly controlled, referred to as joint ventures, are accounted for using proportionate consolidation; entities which are not controlled and over which the Corporation has the ability to exercise significant influence, referred to as associated companies, are accounted for using the equity method; and investments in other entities are accounted for using the cost method.

(B) TRANSLATION OF FOREIGN CURRENCIES

The consolidated financial statements are expressed in U.S. dollars as the greater part of the earnings and the net assets of Nortel are denominated in U.S. dollars.

Self-sustaining operations, which comprise most of the Corporation's subsidiaries, are those whose economic activities are largely independent of those of the Corporation as a parent company. Assets and liabilities are translated at the exchange rates in effect at the balance sheet date. Revenues and expenses, including gains and losses on foreign exchange transactions other than long-term intercompany advances, are translated at average rates for the period. The unrealized translation gains and losses on the Corporation's net investment, including long-term intercompany advances, in these operations are accumulated in a separate component of shareholders' equity, described in the consolidated balance sheets as currency translation adjustment (CTA). Exchange gains or losses on certain debt designated as partial hedges of foreign self-sustaining operations are also included in CTA. These gains and losses may become realized on the payment of dividends by, or a change in the equity capital of, a self-sustaining operation, in which event an appropriate portion of CTA is recognized in net earnings.

Integrated subsidiaries are financially or operationally dependent on the Corporation as a parent company. Monetary assets and liabilities are translated at the exchange rates in effect at the balance sheet date. Non-monetary assets and liabilities are translated at historical rates. Revenues and expenses are translated at average rates for the period. Translation exchange gains or losses of integrated subsidiaries and those subsidiaries operating in hyperinflationary economic environments are reflected in net earnings.

(C) REVENUE RECOGNITION

Revenues, excluding software revenues, are recognized using the percentage-of-completion method or upon shipment of the product, as appropriate. Software revenues are recognized upon performance of all contractual obligations or in accordance with the percentage-of-completion method, as appropriate.

(D) DEPRECIATION

Depreciation is calculated generally on the straight-line method using rates based on the expected useful lives of the assets. The expected useful lives of buildings are twenty to forty years, and of machinery and equipment are three to sixteen years.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Northern Telecom Limited (millions of U.S. dollars except per share figures and unless otherwise stated)

(E) RESEARCH AND DEVELOPMENT

Research and development (R&D) costs are charged to earnings in the periods in which they are incurred, except for costs incurred pursuant to specific contracts with third parties, which are charged to earnings in the same period as the related revenue is recognized. Related investment tax credits reduce R&D expense in the same period in which the related expenditures are charged to earnings, provided there is reasonable assurance the benefits will be realized. Computer software development costs for specified internal applications have been deferred and are being amortized on a straight-line basis over three to five years.

(F) INCOME TAXES

Nortel provides for income taxes based on accounting income using the deferral method. Under this method, taxes are computed using current tax rates regardless of when such income is subject to taxes under the tax laws. The deferred tax balances which result are not adjusted for any subsequent changes in tax rates and include benefits related to investment tax credits.

(G) CASH EQUIVALENTS

All highly liquid investments with original maturities of three months or less are classified as cash and short-term investments.

(H) INVENTORIES

Inventories are valued at the lower of cost (calculated generally on a first-in, first-out basis) and net realizable value. The cost of finished goods and work in process comprise material, labor, and manufacturing overhead.

(I) GOODWILL

Goodwill represents the excess at the dates of acquisition of the costs over the fair values of the net assets of both subsidiary companies and associated companies, and is amortized on a straight-line basis over the estimated lives to a maximum of forty years. Nortel evaluates the carrying value of goodwill for potential permanent impairment on an on-going basis. In order to determine if such a permanent impairment exists, Nortel's management considers each business unit's financial condition and expected future earnings before tax using projected financial performance. A permanent impairment in the value of goodwill is written off against earnings in the year such impairment is recognized.

(J) EARNINGS PER COMMON SHARE

Earnings per common share are calculated after deducting dividends on preferred shares from net earnings and are based on the weighted average number of common shares outstanding during the period.

(K) FINANCIAL INSTRUMENTS

Nortel accounts for financial instruments as follows: gains and losses on forwards and cross currency swaps designated as hedges of foreign net investments are deferred and reported as part of CTA, as outlined in note I(b); gains and losses related to hedges of anticipated transactions are deferred and recognized in income as adjustments to the carrying amounts when the hedged transaction occurs; amounts receivable or payable under interest rate swaps are accrued and recorded as adjustments to interest expense; any premiums paid with respect to financial instrument contracts are deferred and expensed to earnings over the contract period.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Nortel Telecom Limited (millions of U.S. dollars except per share figures and unless otherwise stated)

(L) USE OF ESTIMATES

The preparation of Nortel's financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(M) STOCK-BASED COMPENSATION COSTS

Stock-based compensation costs are based on the fair value of each option at the grant date. The option value is calculated using the Black-Scholes option-pricing model.

2. RESEARCH AND DEVELOPMENT

	1996	1995	1994
Research and development expense	\$1,813	\$1,579	\$1,156
Research and development costs incurred on behalf of others*	166	173	145
Total	\$1,979	\$1,752	\$1,301

* These costs include R&D charged to customers of Nortel pursuant to contracts that provide for full recovery of the estimated cost of development, material, engineering, installation and all other attracted costs, which are accounted for as contract costs.

The above amounts, which are net of global investment tax credits of \$118, \$120, and \$109 in 1996, 1995, and 1994, respectively, exclude spending related to the software initiative (and charged to provisions) of nil, \$65, and \$69 for 1996, 1995, and 1994, respectively. Effective 1994, certain costs primarily representing product design verification and testing activities, which had been recorded principally as cost of revenues, were reclassified to R&D expense.

3. GOODWILL AMORTIZATION

Total goodwill amortization charged to operations, including that in equity in net earnings of associated companies, for the years ended December 31, 1996, 1995, and 1994 was \$45, \$39, and \$23, respectively.

4. INVESTMENT AND OTHER INCOME - NET

	1996	1995	1994
Interest income	\$100	\$140	\$128
Royalty income	33	25	20
Currency exchange gains (losses)	(44)	(2)	82
Gain on reduction in ownership of subsidiary stock*	19	—	—
Other	(61)	(56)	(30)
Investment and other income - net	\$ 47	\$107	\$200

* During 1996, Nortel formed a new subsidiary, Entrust Technologies Inc. (Entrust), to carry on the business of the secure networks business unit of enterprise networks and provide public key infrastructure software products for the encryption and digital signature of information communicated between client workstations over the Internet and intranets. On December 31, 1996, Entrust issued 260,000 Series B Common Shares for total cash consideration of \$26, which reduced Nortel's ownership interest in Entrust to 72.9 percent.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Northern Telecom Limited (millions of U.S. dollars except per share figures and unless otherwise stated)

5. SALES OF BUSINESSES

Effective February 2, 1996, Nortel sold its structured wiring and copper wire and cable business to Cable Design Technologies (CDT) Canada Inc., since renamed NORDX/CDT, Inc., for gross proceeds, before closing adjustments, of \$90, resulting in no material gain or loss.

Effective December 30, 1994, Nortel sold its connection, protection, and optical fiber management systems businesses to Siecor Corporation (Siecor) for gross proceeds, before closing adjustments, of \$130, resulting in a gain of \$33. Nortel also entered into a supply agreement with Siecor to purchase these products.

Effective May 1, 1994, Nortel sold Northern Telecom Finance Corporation (NTFC), its wholly owned finance subsidiary in the United States, to General Electric Capital Corporation (GECC) for approximately net book value at closing. Nortel also entered into a long-term operating agreement with GECC to provide financing to customers of Nortel and customers of its distributors in the United States.

On February 28, 1994, Nortel completed the sale of its optical fiber and fiber cable manufacturing facility in Saskatoon, Saskatchewan, for gross proceeds, before closing adjustments, of \$130, resulting in a gain of \$98.

Effective January 12, 1994, Nortel sold its semiconductor manufacturing facility in San Diego, California to SGS-THOMSON Microelectronics Inc. (SGS-THOMSON) for gross proceeds, before closing adjustments, of \$43, resulting in no gain. Nortel also entered into an agreement with SGS-THOMSON to purchase integrated circuits.

Effective January 1, 1994, Nortel sold its STC Submarine Systems business for gross proceeds, before closing adjustments, of £600 million. This transaction reduced goodwill by £500 million (\$740), resulting in no gain.

6. INCOME TAXES

The following is a reconciliation of income taxes calculated at the Canadian combined federal and provincial income tax rate to the income tax provision included in the consolidated statements of operations:

	1996	1995	1994
Income taxes at Canadian rates (1996 - 42.9%, 1995 - 42.9%, 1994 - 42.7%)	\$405	\$303	\$243
Reduction of Canadian taxes applicable to manufacturing profits	3	(15)	(16)
Difference between Canadian rate and rates applicable to United States' and other subsidiaries	(67)	(46)	(28)
Difference between Canadian rate and rates applicable to gain on sales of businesses	-	-	(26)
Other	(20)	(9)	(12)
Income tax provision	\$321	\$233	\$161

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Northern Telecom Limited (millions of U.S. dollars except per share figures and unless otherwise stated)

Details of Nortel's income taxes were:

	1996	1995	1994
Earnings before income taxes			
Canadian	\$ (32)	\$186	\$194
United States and other	976	520	244
Gain on sales of businesses	—	—	131
	\$944	\$706	\$569
Income tax provision			
Canadian	\$ (18)	\$ 11	\$ 24
United States and other	339	222	107
Gain on sales of businesses	—	—	30
	\$321	\$233	\$161
Income tax provision			
Current	\$373	\$132	\$143
Deferred	(52)	101	18
	\$321	\$233	\$161

The deferred portion of the income tax provision results from the recognition of certain revenues and expenses in the financial statements in different periods from those for income tax purposes. The following is a summary of the components:

	1996	1995	1994
Depreciation	\$(14)	\$(20)	\$(8)
Contracts in progress and other income items	4	—	(3)
Restructuring costs and other charges	20	55	109
Gain on sales of businesses	—	11	(26)
Other	(62)	55	(54)
	\$(52)	\$101	\$18

At December 31, 1996, for income tax purposes, Nortel had operating loss carry forwards of approximately \$129 which expire between 1997 and 2001 and approximately \$528 which can be applied indefinitely against future income.

7. RECONCILIATION OF RESULTS REPORTED IN ACCORDANCE WITH CANADIAN GAAP WITH UNITED STATES GAAP

Nortel's accounting policies are consistent in all material aspects with United States GAAP with the following exceptions:

	1996	1995	1994
Net earnings applicable to common shares – Canadian GAAP	\$ 619	\$ 469	\$ 404
Adjustments:			
Statement No. 106 (i)			
In-year impact	(26)	(17)	(18)
Statement No. 109 (ii)			
In-year impact	(33)	(31)	(28)
Statement No. 112 (iii)			
Impact to December 31, 1995	—	(26)	—
In-year impact	—	—	—
Net earnings applicable to common shares – United States GAAP	\$ 560	\$ 395	\$ 358
Earnings per common share – United States GAAP	\$2.17	\$1.56	\$1.42
Common share effect of GAAP difference in year	\$(.23)	\$(.29)	\$(.18)
Cumulative per common share effect of GAAP differences – since January 1, 1993	\$(.80)	\$(.57)	\$(.28)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Northern Telecom Limited (millions of U.S. dollars except per share figures and unless otherwise stated)

The cumulative effect on retained earnings of GAAP differences since January 1, 1993, as at December 31, 1996, 1995, and 1994, was \$(203), \$(146), and \$(72), respectively.

(i) For the purpose of reporting under United States GAAP, the Financial Accounting Standards Board's (FASB) Statement No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions," became effective for fiscal years beginning after December 15, 1992. This standard requires companies to accrue the expected cost of postretirement benefits other than pensions during the years employees provide service to the company. The in-year impact represents the incremental impact of the change from recognizing the cost of postretirement benefits as claims are paid to the method required by Statement No. 106. The following data is based upon the reports from independent consulting actuaries as at December 31:

	1996	1995	1994
Accrued postretirement benefit cost:			
Accumulated postretirement benefit obligation	\$487	\$401	\$386
Plan assets at fair value	(37)	(37)	(35)
Unrecognized prior service cost	(63)	-	-
Unrecognized net gain (loss)	20	2	(18)
Accrued postretirement benefit cost	\$407	\$366	\$333
Postretirement benefit cost:			
Service cost	\$ 19	\$ 13	\$ 14
Interest on projected plan benefits	35	30	27
Return on plan assets	(3)	(2)	(3)
Amortization	4	(1)	-
Postretirement benefit cost	55	40	38
Less: Claims paid and expensed under Canadian GAAP*	14	13	10
U.S. GAAP adjustment for postretirement benefits	\$ 41	\$ 27	\$ 28
In-year impact after tax	\$ 26	\$ 17	\$ 18

* Nortel provides certain health care and life insurance benefits for most of its retired employees. The costs of retiree health care benefits are recognized as claims are paid. Life insurance benefits for retirees are expensed as paid, during the post-employment period.

Assumptions:			
Weighted average discount rate	7.9%	7.9%	7.8%
Expected long-term rate of return on assets	7.9%	8.0%	7.5%
Weighted average health care cost trend rate	8.2%	8.5%	8.0%
Weighted average ultimate health care cost trend rate	5.3%	5.2%	5.3%
Year in which ultimate health care cost trend rate will be achieved	2002	2001	2006
Effect of a 1% increase in the assumed health care cost trend rate for each future year on:			
a) Accumulated postretirement benefit obligation	\$ 37	\$ 27	\$ 31
b) Aggregate of the service and interest cost components of net postretirement benefit cost	\$ 4	\$ 3	\$ 3

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Northern Telecom Limited (millions of U.S. dollars except per share figures and unless otherwise stated)

(ii) For the purpose of reporting under United States GAAP, FASB's Statement No. 109, "Accounting For Income Taxes," became effective for fiscal years beginning after December 15, 1992. This standard requires companies to adopt an asset and liability approach in accounting for income taxes. The in-year impact represents the incremental impact of the change from the deferral method to the method required by Statement No. 109. The following table shows the main items included in deferred income taxes under United States GAAP as at December 31:

	1996	1995
Deferred income taxes:		
Assets:		
Tax benefit of loss carry forwards and tax credits	\$492	\$407
Provisions and reserves	385	330
Postretirement benefits other than pensions	37	36
Pensions	4	15
Other	23	15
	941	803
Valuation allowance	(182)	(125)
Goodwill	(12)	(12)
	747	666
Liabilities:		
Provisions and reserves	307	294
Depreciation	121	135
Other	27	45
	455	474
Net deferred income taxes	\$292	\$192

(iii) For the purpose of reporting under United States GAAP, FASB's Statement No. 112, "Employers' Accounting for Postemployment Benefits," requires companies to accrue the expected cost of benefits to former or inactive employees after employment but before retirement. The net accrued postemployment benefit cost that had not been accrued under Canadian GAAP as at December 31, 1996 and 1995 was \$41 and \$41, respectively. Prior to December 31, 1995, the effect of Statement No. 112 was not considered material.

(iv) For the purposes of reporting under United States GAAP, FASB's Statement No. 95, "Statement of Cash Flows," requires additional disclosures not required under Canadian GAAP. These disclosures are as follows:

	1996	1995	1994
Income taxes paid	\$251	\$134	\$ 35
Interest paid	\$181	\$159	\$195

(v) For the purposes of reporting under United States GAAP, dilutive common share equivalents (which include convertible securities and stock options) are included in the calculation of earnings per share. For 1996, 1995, and 1994, the number of shares used to calculate earnings per share under United States GAAP was not materially different from the number of shares used to calculate earnings per share under Canadian GAAP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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(vi) At December 31, 1996 and 1995, there were no material differences between balance sheet item amounts calculated under United States GAAP and those calculated under Canadian GAAP and shown on Nortel's consolidated balance sheets, with the exception of the effect of proportionately consolidating the operations that are under joint control as disclosed in note 21, the "accrued postretirement benefit cost" as disclosed in part (i) of this note, "net deferred income taxes" as disclosed in part (ii) of this note, and the "net accrued post-employment benefit cost" as disclosed in part (iii) of this note.

8. INVENTORIES

At December 31, inventories consisted of:

	1996	1995
Raw materials	\$ 474	\$ 478
Work in process	404	345
Finished goods	801	820
	<u>\$1,679</u>	<u>\$1,643</u>

9. PLANT AND EQUIPMENT

At December 31, plant and equipment consisted of:

	1996	1995
Cost:		
Land	\$ 92	\$ 88
Buildings	929	892
Machinery and equipment	3,659	3,553
	<u>4,680</u>	<u>4,533</u>
Less accumulated depreciation:		
Buildings	301	290
Machinery and equipment	2,344	2,320
	<u>2,645</u>	<u>2,610</u>
	<u>\$2,035</u>	<u>\$1,923</u>

10. RESTRUCTURING COSTS AND OTHER CHARGES

On July 21, 1993, the Corporation announced \$1,161 in special charges for a restructuring program (\$409 pre-tax), a new software initiative (\$252 pre-tax), and a goodwill write-down (\$500).

At December 31, 1996, the remaining restructuring and software initiative provisions included in other accrued liabilities were nil and nil, respectively. At December 31, 1995, the outstanding provisions were \$38 and nil, respectively. Both provisions have been fully utilized.

11. PLANS FOR EMPLOYEES' PENSIONS

Nortel has non-contributory defined benefit pension plans covering substantially all of its employees. The benefits are based on length of service and rates of compensation.

Nortel's policy is to fund pensions based on widely used actuarial methods as permitted by pension regulatory authorities. The funded amounts reflect actuarial assumptions regarding compensation, interest, and other projections. Plan assets are represented primarily by common stocks, bonds, debentures, secured mortgages, and property. Included in plan assets are common shares and debentures of BCE Inc. (BCE) and debentures of Bell Canada with an aggregate market value of \$13 (\$11 in 1995).

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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Pension costs reflected in the consolidated statements of operations are based on the unit credit method of valuation of pension plan benefits. Within the consolidated balance sheets, pension plan assets are included in other assets and pension plan liabilities are included in other liabilities. The following are details of the funded status of the plans and amounts recognized in the consolidated balance sheets as at December 31:

	Deferred pension asset		Deferred pension liability	
	1996	1995	1996	1995
Funded status:				
Actuarial present value of:				
Vested benefit obligation	\$1,766	\$1,625	\$1,669	\$1,633
Accumulated benefit obligation	\$1,833	\$1,682	\$1,754	\$1,724
Projected benefit obligation	\$2,115	\$1,921	\$1,943	\$1,905
Plan assets at fair value	\$2,440	\$2,168	\$1,565	\$1,457
Excess (deficiency) of plan assets at fair value over projected plan benefits	325	247	(378)	(448)
Unrecognized net plan (benefits) obligations existing at January 1, 1987	(18)	(20)	19	32
Other unrecognized net plan (benefits) obligations and amendments	(49)	5	152	218
Net accrued pension asset (liability)	\$ 258	\$ 232	\$ (207)	\$ (198)
		1996	1995	1994
Pension expense:				
Service cost – benefits earned		\$114	\$110	\$104
Interest cost on projected plan benefits		322	302	272
Estimated return on plan assets		(319)	(296)	(283)
Amortization of net pension plan benefits and amendments		59	53	69
Net pension expense		\$176	\$169	\$162
Assumptions:				
Discount rates		8.3%	8.3%	8.3%
Rate of return on assets		8.6%	8.6%	8.6%
Rate of compensation increase		4.5%	5.3%	4.9%
Amortization period (years)		12.8	12.5	13.0

CAN pension asset = $\frac{258}{20777} = 51\%$

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Northern Telecom Limited (millions of U.S. dollars except per share figures and unless otherwise stated)

12. LONG-TERM DEBT

At December 31, long-term debt consisted of:

	1996	1995
67/8% Notes due October 1, 2002	\$ 300	\$ 300
83/4% Notes due June 12, 2001, swapped to U.K. pounds, principal and interest of 10.75% (i)	250	250
7.45% Notes (C\$300 million) due March 9, 1998, swapped to U.K. pounds, principal and interest with an average floating rate of 5.89% (i)	219	220
67/8% Notes due September 1, 2023	200	200
6% Notes due September 1, 2003	200	200
7.875% Notes due June 15, 2026*	150	—
7.40% Notes due June 15, 2006*	150	—
81/4% Notes due June 12, 1996 swapped to U.K. pounds, principal and interest of 10.60% (i)	—	250
9.60% Notes due in equal annual installments, of the finance subsidiary	—	60
Other long-term debt including obligations under capital leases	199	77
	1,668	1,557
Less: Amount included in current liabilities	5	336
	\$1,663	\$1,221

* Notes issued by Northern Telecom Capital Corporation, an indirect wholly owned finance subsidiary of the Corporation. The payment of principal of, premium, if any, and interest on, such Notes is wholly and unconditionally guaranteed by the Corporation.

(i) Designated as a hedge of foreign currency exposure relating to Nortel's net investment in the United Kingdom. Long-term debt is presented at face value, with the net value of each swap reflected in long-term assets or long-term liabilities as appropriate.

At December 31, 1996, the amounts of long-term debt payable (excluding obligations under capital leases), for the years 1997 through 2001 were \$4, \$292, \$7, \$31, and \$327, respectively.

13. COMMITMENTS

At December 31, 1996, the future minimum lease payments under capital leases and operating leases consisted of:

	Capital leases	Operating leases
Year ended December 31:		
1997	\$ 2	\$175
1998	2	130
1999	2	93
2000	—	68
2001	1	59
Thereafter	—	230
Total future minimum lease payments	7	\$755
Less: Imputed interest	2	
Present value of net minimum lease payments	\$ 5	

Rental expense on operating leases for the years ended December 31, 1996, 1995, and 1994, amounted to \$238, \$197, and \$160, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Northern Telecom Limited (millions of U.S. dollars except per share figures and unless otherwise stated)

14. CONTINGENCIES

In 1993, certain holders of the Corporation's securities commenced a class action in the United States District Court for the Southern District of New York alleging that the Corporation and certain of its officers violated the Securities Exchange Act of 1934 and common law by making material misstatements of, or omitting to state, material facts relating to the business operations and prospects and financial condition of the Corporation. At this stage of the action, the Corporation cannot determine whether the action will have a material adverse impact on the consolidated financial position or results of operations of the Corporation.

Nortel, primarily as a result of its manufacturing operations, is subject to numerous environmental laws and regulations and is exposed to liabilities and compliance costs arising from its past and current generation, management, and disposition of hazardous substances and wastes.

At December 31, 1996, the accruals on the Corporation's consolidated balance sheet for environmental matters, including those referred to below, were \$50. It is anticipated that a majority of the accruals will be spent over the next three years. Based on information presently available, management believes that the existing accruals are sufficient to satisfy probable and reasonably estimable environmental liabilities related to known environmental matters. Any additional liability that may result from these matters, and any additional liabilities that may result in connection with other sites currently under investigation, are not expected to have a material adverse impact on the consolidated financial position or results of operations of the Corporation.

Nortel has remedial activities under way at nine manufacturing sites and seven previously occupied sites. An estimate of Nortel's anticipated remediation costs associated with all such sites, to the extent probable and reasonably estimable, is included in the environmental accruals referred to above in an approximate amount of \$48.

Moreover, Nortel has been named as a potentially responsible party (PRP) under the U.S. Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) at six Superfund sites in the United States and is listed as a *de minimis* PRP at three of these Superfund sites. An estimate of Nortel's share of the anticipated remediation costs associated with such Superfund sites is included in the environmental accruals referred to above.

Liability under CERCLA may be imposed on a joint and several basis, without regard to the extent of Nortel's involvement. In addition, the accuracy of Nortel's estimate of environmental liability is affected by several uncertainties such as additional requirements that may be identified in connection with remedial activities, the complexity and evolution of environmental laws and regulations, and the identification of presently unknown remediation sites. Consequently, Nortel's liability could be greater than its current estimate.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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15. PREFERRED SHARES

The Corporation is authorized to issue an unlimited number of Class A Preferred Shares and Class B Preferred Shares, without nominal or par value, issuable in series. Class A Preferred Shares have been issued for consideration denominated in Canadian dollars (C\$). Each series of Class A Preferred Shares ranks in parity with every other series of Class A Preferred Shares. At December 31, outstanding preferred shares included in shareholders' equity consisted of:

	1996		1995		1994	
	Number of shares	Amount	Number of shares	Amount	Number of shares	Amount
Cumulative Redeemable Class A:						
Series 4, issued June 25, 1985 for consideration of C\$100 million	200	\$ 73	200	\$73	200	\$73
Series 5, issued November 26, 1996 for consideration of C\$400 million	16,000,000	294	—	—	—	—
	16,000,200	\$367	200	\$73	200	\$73

The Cumulative Redeemable Class A Preferred Shares Series 4 (Series 4 Shares) are presented in U.S. dollars after translation at the exchange rate in effect at the date of original issue. The dividend rate on the Series 4 Shares is determined by auctions held at intervals of approximately one month on the business day immediately preceding the commencement of each dividend period. The Corporation can neither participate, nor oblige any subsidiary to participate, in the auction procedures. The annual dividend rate may not exceed the Bankers' Acceptance Rate in effect on the auction date plus .40 percent. The annual dividend rate in effect on December 31, 1996, 1995, and 1994 was 2.29 percent, 4.10 percent, and 6.33 percent, respectively. The Corporation may call all or a part of the Series 4 Shares for redemption at a price of C\$500,000 per share, on the business day immediately preceding any auction date. Dividends on the outstanding Series 4 Shares are declared and payable in Canadian dollars. Amounts equal to accrued and unpaid dividends are payable by the Corporation upon redemption of the Series 4 Shares. The applicable dividend must be declared prior to redemption.

On July 8, 1994, the Corporation issued 200 Exchange Rights to the holders of its Series 4 Shares without cost to such holders. The Exchange Rights entitle the holders to exchange each Exchange Right, together with one Series 4 Share, for that number of common shares determined by dividing C\$500,000 by the greater of C\$2.50 and 95 percent of the weighted average trading price of the common shares on The Toronto Stock Exchange for the ten trading days ending immediately preceding the exchange date. The Exchange Rights will be of no force or effect until the occurrence of two consecutive unsuccessful auctions in which there are not sufficient clearing bids to determine a dividend rate in respect of the Series 4 Shares. At December 31, 1996, no Exchange Rights had been exercised. An Exchange Right has no value except in connection with a Series 4 Share.

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The Cumulative Redeemable Class A Preferred Shares Series 5 (Series 5 Shares) are presented net of tax effected issue costs of approximately \$4, in U.S. dollars after translation at the exchange rate in effect at the date of original issue. The Series 5 Shares will, until December 1, 2001, pay an annual fixed cumulative preferential cash dividend of C\$1.275 per share (5.1 percent), payable, if declared, quarterly on the first day of March, June, September, and December. The initial dividend will be payable, if declared, on March 1, 1997. From December 1, 2001, the Series 5 Shares will pay, if declared, a monthly floating cumulative preferential dividend. Holders of Series 5 Shares will have the right to convert their shares into Cumulative Redeemable Class A Preferred Shares Series 6 (Series 6 Shares), subject to certain conditions, on December 1, 2001, and on December 1 of every fifth year thereafter. The Series 6 Shares will have a similar right to convert back into Series 5 Shares every five years. In certain circumstances, conversions may be automatic. The Series 5 Shares are not redeemable prior to December 1, 2001, at which time they will be redeemable at the Corporation's option at C\$25 per share. The Series 5 Shares will be redeemable after that date at the Corporation's option at C\$25.50 per share. The Series 6 Shares will also be redeemable at the Corporation's option at C\$25 per share on December 1, 2006, and on December 1 of every fifth year thereafter.

16. COMMON SHARES

The Corporation is authorized to issue an unlimited number of common shares without nominal or par value. Outstanding common shares during the year ended December 31 were:

	1996		1995		1994	
	Number of shares	Amount	Number of shares	Amount	Number of shares	Amount
January 1	254,353,580	\$1,273	253,353,915	\$1,245	251,265,697	\$1,183
Issued during the year	5,522,612	188	999,665	28	2,088,218	62
December 31	259,876,192	\$1,461	254,353,580	\$1,273	253,353,915	\$1,245

At December 31, 1996 and 1995, BCE owned 51.6 percent and 52.1 percent of the outstanding common shares, respectively. Common shares issued during the year ended December 31 and listed for future issuance under the following plans were:

	Issued			Listed
	1996	1995	1994	1996
Shareholder Dividend Reinvestment and Stock Purchase Plan	50,184	62,165	1,576,433	4,055,421
Investment Plan for Employees – Canada	—	—	82,335	2,000,173
Long-term Investment Plan – U.S.	—	—	—	177,235
Stock Option Plan (note 17)	5,472,428	937,500	429,450	14,121,667
	5,522,612	999,665	2,088,218	20,354,496

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17. STOCK OPTIONS

In January 1986, the Corporation introduced the Northern Telecom Limited 1986 Stock Option Plan, under which options to purchase common shares of the Corporation may be granted to employees of Nortel. Each option granted under the plan as amended and restated from time to time (the Plan) entitles the holder to purchase one common share at a subscription price of not less than 100 percent of the market value of such share on the effective date of the grant. Subscription prices are stated in U.S. dollars for U.S. options and in Canadian dollars for Canadian options. Generally, the holder has the right to exercise half of his options after one year (two years for pre-1991 grants), and the remainder after two years (three years for pre-1991 grants), from the effective date of the grant. The committee that administers the plan (the committee) has the discretion to vary the period during which the holder has the right to exercise his options and, in certain circumstances, may accelerate the right of the holder to exercise his options but in no case shall the exercise period be later than ten years after the effective date of the grant. Each option may be granted with or without a stock appreciation right (SAR). A SAR entitles the holder to receive payment of an amount equivalent to the excess of the market value of a common share at the time of exercise of the SAR over the subscription price of the common share to which the option relates. Options with SARs may be granted on a cancellation basis, in which case the exercise of one causes the cancellation of the other, or on a simultaneous basis, in which case the exercise of one causes the exercise of the other. In September 1996, the committee determined that the stock options/SARs granted after January 1, 1997, will generally vest 33 1/3 percent on each of the first, second, and third anniversaries of the date of grant.

The original number of common shares to be covered by options granted over the ten year life of the Plan was ten million shares. In 1992, and subsequently in 1995, the shareholders of the Corporation approved amendments to the Plan, including increasing the maximum number of common shares to be covered by options granted to twenty-five million common shares and thirty-four million common shares (not including the 4,714,755 shares issued on the exercised options prior to April 27, 1995), respectively. The shareholder approval in 1995 also increased the maximum number of common shares with respect to which options may be made on an annual basis to 2.0 percent of the common shares issued and outstanding at the commencement of the year, beginning in 1995. In April 1993, the board of directors of the Corporation reserved for issuance an additional fifteen million common shares pursuant to the Plan, of which seven million were listed for issuance in June 1993 and eight million were listed for issuance in January 1995. In September 1996, the board of directors of the Corporation reserved for issuance the additional 13,714,755 common shares, ten million of which were listed for issuance in January 1997. The Corporation will provide the shares available upon exercise of options either by issuance or by purchase on the open market.

In 1993, the Corporation granted an aggregate of 150,000 options exercisable after five years, and 402,200 options, of which 50 percent were exercisable after two years and 100 percent after three years, all from the effective date of the grant.

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In January 1995, a key contributor stock option program (the Program) was established under the Plan. Under the terms of the Program, participants are granted an equal number of initial options and replacement options. The initial options generally vest after five years and expire ten years from the date of grant. The replacement options are granted concurrently with the initial options and also expire ten years from the date of grant. The replacement options generally have an exercise price equal to the market value of the common shares of the Corporation on the day the initial options are fully exercised, and are generally exercisable commencing thirty-six months thereafter, provided certain other conditions for exercise, including share ownership, are met. In January 1995 and 1996, respectively, 1,500,000 and 1,040,000 options were granted pursuant to the Program under the Plan.

At December 31, 1996, 10,878,333 common shares had been issued pursuant to stock option exercises and 14,121,667 common shares remained listed with various stock exchanges for issuance under the Plan (note 16).

The following is a summary of the maximum number of common shares issuable pursuant to outstanding stock options and available for future issuance:

	Outstanding			Available for Issuance
	1996	1995	1994	1996
January 1	13,505,835	9,968,320	7,020,295	5,658,860
Increase (decrease) resulting from:				
Grant of additional options	5,221,550	5,423,725	3,710,800	(5,221,550)
Exercise of options	(5,472,428)	(937,500)	(429,450)	—
Exercise of SARs	(20,500)	(6,650)	—	—
Cancellation of options	(561,140)	(942,060)	(333,325)	561,140
December 31	12,673,317	13,505,835	9,968,320	998,450
Exercisable (vested) at December 31	4,616,224	6,420,338	4,708,744	

The 12,673,317 and 13,505,835 shares under option as at December 31, 1996 and 1995, respectively, were exercisable at a weighted average subscription price per share of approximately \$39.00 (C\$54.00) and \$35.00 (C\$47.00), respectively. Options which have been granted with SARs are exercisable on a cancellation basis. At December 31, 1996, 161,475 SARs were outstanding at a weighted average subscription price per share of approximately \$25.00 (C\$34.00). At December 31, 1995, 510,325 SARs were outstanding at a weighted average subscription price per share of approximately \$24.00 (C\$33.00). SARs exercisable as at December 31, 1996 and 1995, were 8,000 and 28,000, respectively.

The range of prices for options granted, exercised, and canceled and for SARs exercised were as follows:

	1996 High/Low	1995 High/Low	1994 High/Low
U.S. dollars			
Grant of additional options	\$60.80/44.94	\$36.32/33.69	\$35.19/28.94
Exercise of options	\$48.56/14.00	\$39.15/14.00	\$33.81/15.70
Exercise of SARs	\$29.31/15.70	\$19.53/15.70	—
Cancellation of options	\$58.50/24.87	\$48.56/23.94	\$48.56/15.70
Canadian dollars			
Grant of additional options	C\$80.02/61.88	C\$51.60/47.65	C\$47.23/40.00
Exercise of options	C\$57.31/18.56	C\$57.31/18.56	C\$44.44/18.56
Exercise of SARs	—	C\$26.21/19.74	—
Cancellation of options	C\$61.88/32.89	C\$57.31/32.89	C\$57.31/28.50

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The Corporation does not recognize a compensation expense for its stock-based compensation plans. Had compensation cost for the stock option plan been determined based upon the fair value at the grant date for awards under these plans consistent with the methodology prescribed under FASB's Statement No. 123, "Accounting for Stock-Based Compensation," the Corporation's net earnings applicable to common shares and earnings per common share would have been reduced to the pro forma amounts indicated below:

	1996	1995
Net earnings applicable to common shares		
Per Canadian GAAP	\$ 619	\$ 469
Pro forma	\$ 526	\$ 388
Earnings per common share		
Per Canadian GAAP	\$2.40	\$1.85
Pro forma	\$2.04	\$1.53

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants in 1996 and 1995: dividend yield of .93 percent and 1.12 percent, respectively; expected volatility of 33.58 percent and 32.56 percent, respectively; risk-free interest rate of 6.02 percent and 7.50 percent, respectively; and an expected option life of seven years for both 1996 and 1995.

18. CURRENCY TRANSLATION ADJUSTMENT

The following is an analysis of the currency translation adjustment included in shareholders' equity as at December 31:

	1996	1995	1994
January 1	\$(275)	\$(328)	\$(294)
Translation of self-sustaining operations	107	74	50
Impact of foreign currency hedges	(74)	(21)	(84)
December 31	\$(242)	\$(275)	\$(328)

19. CHANGES IN NON-CASH WORKING CAPITAL COMPONENTS

Changes in the components of working capital, excluding cash and short-term investments, notes payable, and current portion of long-term debt, for the year ended December 31 were:

	1996	1995	1994
(Increase) decrease in:			
Accounts receivable	\$(397)	\$ (545)	\$ 60
Inventories	(34)	(412)	38
Prepaid expenses	(4)	14	(10)
Deferred income taxes	(72)	80	24
Increase (decrease) in:			
Accounts payable and accrued liabilities	340	(161)	(34)
Income taxes payable	65	(33)	76
Effect of foreign currency fluctuations on working capital items	4	(8)	(36)
(Increase) decrease in non-cash working capital components	\$ (98)	\$(1,065)	\$118

Nortel has programs in place to sell trade accounts receivables. At December 31, 1996 and 1995, Nortel had sold, with limited recourse, trade accounts receivable for cash proceeds of approximately \$476 and \$325, respectively, at an effective discount rate of 5.9 percent and 6.4 percent, respectively.

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20. INVESTMENTS

In June 1996, Nortel acquired all of the outstanding common shares of MICOM Communications Corp. (MICOM), a manufacturer and distributor of integrated networking solutions, for an aggregate purchase price of approximately \$150. The acquisition has been accounted for by the purchase method of accounting. Goodwill in the amount of \$115 in connection with the acquisition of MICOM is being amortized on a straight-line basis over a ten year period.

In June 1994, Nortel and Lagardère SCA (Lagardère) signed an agreement pursuant to which Nortel and Lagardère each hold, directly or indirectly, 50 percent of Matra Communication S.A.S. (Matra Communication). Nortel's proportionate share of Matra Communication is included in the consolidated statements of operations and the consolidated statements of cash flows for the years ended December 31, 1996 and 1995, and the consolidated balance sheets as at December 31, 1996 and 1995.

In a related agreement, Lagardère may, under specific circumstances, require Nortel to purchase all or part of its equity participation in Matra Communication at a formula price, currently estimated at approximately 1.8 billion French francs (approximately \$335) for all its equity participation, with consideration consisting of a long-term interest-bearing note.

21. INTERESTS IN JOINT VENTURES

Included in the consolidated statements of operations and the consolidated statements of cash flows for the years ended December 31, 1996 and 1995, and the consolidated balance sheets as at December 31, 1996 and 1995, and as summarized below, is Nortel's proportionate share of interests in joint ventures, including goodwill attributable to the joint ventures. A substantial portion of the amounts proportionately consolidated relates to the operations of Matra Communication (note 20). Prior to 1995, the equity method was used to account for these joint ventures.

For purposes of reporting under United States GAAP, the Accounting Principles Board Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock," requires the use of the equity method of accounting for joint ventures. This difference in accounting standards has no effect on the net earnings of the Corporation.

	As at December 31	
	1996	1995
Total assets	\$ 1,029	\$ 1,092
Total liabilities	\$ 571	\$ 644
	Year ended December 31	
	1996	1995
Revenues	\$ 928	\$ 830
Net loss	\$ 56	\$ 71
Cash flow from operating activities	\$ (21)	\$ (36)
Cash flow from investing activities	(71)	(59)
Cash flow from financing activities	66	85
Total cash flow	\$ (26)	\$ (10)

Effective July 28, 1995, Nortel and Olivetti S.p.A. (Olivetti), an Italian company, formed a joint venture. Under the terms of the agreement between Nortel and Olivetti, Nortel acquired a 49 percent ownership interest in Sixel S.p.A. The remaining 51 percent ownership interest is owned by Olivetti. Nortel and Olivetti exercise joint control.

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On March 10, 1995, Nortel and Daimler-Benz Aerospace AG of Germany announced the formation of a joint venture with equal ownership. The company, Nortel Dasa Network Systems GmbH & Co. KG, commenced operations in the second quarter of 1995. Nortel contributed a major portion of the existing assets of its German subsidiary, Northern Telecom GmbH, to the joint venture, and has funded, and will continue to fund an equal share of the cash flow requirements.

22. INFORMATION ON BUSINESS SEGMENT BY GEOGRAPHIC AREAS

BUSINESS SEGMENT

Nortel operates in one business segment, telecommunications equipment, which consists of the research and the design, development, manufacture, marketing, sale, installation, financing, support, and servicing of switching networks, enterprise networks, wireless networks, broadband networks, and other products and services.

GEOGRAPHIC AREA

The point of origin (the location of the selling organization) of revenues and the location of the assets determine the geographic areas. The following table sets forth information by geographic area for the year ended December 31:

	1996	1995	1994
Total revenues			
United States			
Customers	\$ 7,401	\$ 5,812	\$ 5,437
Transfers between geographic areas	1,067	647	435
	8,468	6,459	5,872
Canada			
Customers	1,489	1,461	1,476
Transfers between geographic areas	2,777	2,379	2,002
	4,266	3,840	3,478
Europe			
Customers	3,001	2,569	1,508
Transfers between geographic areas	596	381	98
	3,597	2,950	1,606
Other			
Customers	956	830	453
Transfers between geographic areas	152	128	116
	1,108	958	569
Elimination of transfers between geographic areas	(4,592)	(3,535)	(2,651)
Total customer revenues	\$12,847	\$10,672	\$ 8,874
Contribution to operating earnings			
United States	\$ 1,900	\$ 1,450	\$ 1,338
Canada	712	671	353
Europe	703	443	135
Other	5	35	7
	3,320	2,599	1,833
Research and development expense	(1,813)	(1,579)	(1,156)
General corporate expenses	(427)	(268)	(268)
Operating earnings	1,080	752	409
Other income less non-operating expenses	(136)	(46)	29
Gain on sales of businesses	—	—	131
Earnings before income taxes	\$ 944	\$ 706	\$ 569

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Northern Telecom Limited, (millions of U.S. dollars except per share figures and unless otherwise stated)

	1996	1995	1994
Identifiable assets			
United States	\$ 4,213	\$ 3,482	\$ 3,485
Canada	2,274	2,052	2,040
Europe	2,778	3,291	3,323
Other	879	964	453
Adjustments and eliminations	(1,004)	(1,249)	(1,218)
Identifiable assets	9,140	8,540	8,083
Corporate assets	1,763	940	714
Total assets	\$10,903	\$ 9,480	\$ 8,797

Transfers between geographic areas are made at prices based on total cost of the product to the supplying segment.

Customer revenues by destination for the year ended December 31 were:

	1996	1995	1994
United States	\$ 6,858	\$ 5,345	\$ 4,851
Canada	1,233	1,138	1,144
Europe	3,029	2,590	1,583
Other	1,727	1,599	1,296
Total	\$12,847	\$10,672	\$ 8,874

Of the total customer revenues, including R&D, revenues from Bell Canada and other subsidiaries and associated companies of BCE, including associated companies of Nortel, accounted for \$835, \$737, and \$691, for 1996, 1995, and 1994, respectively. Export sales, defined as revenues from Canada to customers outside Canada, and intercompany transfers out of Canada, amounted to \$3,033, \$2,708, and \$2,410 for the years ended December 31, 1996, 1995, and 1994, respectively.

Operating earnings represent total revenues less operating expenses. In computing segmented operating earnings, the following items have been excluded: equity in net earnings of associated companies, investment and other income – net, interest expense, general corporate expenses, R&D expense, and income tax provision.

Identifiable assets are those assets of Nortel that are identified with the operations in the geographic area. Corporate assets are principally cash and short-term investments and corporate plant and equipment.

23. FINANCIAL INSTRUMENTS AND HEDGING ACTIVITIES

Nortel operates internationally, which gives rise to a risk that its earnings and cashflows may be negatively impacted by fluctuations in interest and foreign exchange rates, and by the volatility of those rates. Nortel enters into foreign currency forward contracts, swaps, and options to manage those risks. If Nortel did not use derivative financial instruments, its exposure to financial risks would be higher. Nortel does not hold or issue financial instruments for trading purposes.

Nortel enters into long-term cross currency swaps and short-term forward contracts to limit its exposure to foreign currency fluctuations on its investments in the United Kingdom and France. These cross currency swaps involve either swapping the underlying debt denominated in U.S. and Canadian dollars to U.K. pounds, as discussed in note 12 or exchanging U.S. dollars for French francs. The notional principal amount of the French franc denominated swaps was \$268 as at December 31, 1996 and 1995. Nortel had short-term forward contracts outstanding to purchase and sell the equivalent of \$750 and \$516 as at December 31, 1996 and 1995, respectively, related to these investments.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Northern Telecom Limited, (millions of U.S. dollars, except per share figures and unless otherwise stated)

Nortel enters into U.S. to Canadian dollar option contracts intended to hedge the U.S. to Canadian dollar exposure on future revenue and expenditure streams. At December 31, 1996, Nortel had \$839 of option contracts outstanding, which were principally between sixty days and two years in duration. Nortel also enters into forward contracts, denominated in various currencies, mainly in Canadian and U.S. dollars and U.K. pounds, over terms of thirty days to two years, to limit its exposure to exchange fluctuations on existing assets and liabilities and on future revenue and expenditure streams. At December 31, 1996 and 1995, Nortel had forward contracts outstanding to purchase and sell the equivalent of \$1,081 and \$588, respectively, related to these assets and liabilities and revenue and expenditure streams.

Nortel enters into interest rate swap agreements to minimize financing costs on long-term debt and to manage interest rate risk on existing liabilities and receivables due to interest rate fluctuations. These agreements are denominated in various currencies and are swapped from floating rate payments to fixed rate payments or vice versa. The following table indicates the types of swaps used and their aggregated weighted-average interest rates. Average floating rates are based on rates implied in the yield curve at the reporting date; those may change significantly, affecting future cash flows. These swap contracts primarily have remaining terms to maturity of between one and seven years.

	1996	1995
Receive-fixed swaps – notional amount	\$ 639	\$ 850
Average fixed rate received	8.4%	8.4%
Average floating rate paid	5.6%	6.8%
Pay-fixed swaps – notional amount	\$ 798	\$1,083
Average fixed rate paid	8.0%	8.4%
Average floating rate received	5.4%	6.6%

The estimated fair values approximate amounts at which these instruments could be exchanged in a current transaction between willing parties. Therefore, fair values are based on estimates using present value and other valuation techniques which are significantly affected by the assumptions used concerning the amount and timing of estimated future cash flows and discount rates which reflect varying degrees of risk. Specifically, long-term debt instruments reflect a current yield valuation based on Nortel's incremental borrowing rate, interest rate swaps and forward contracts reflect the present value of the potential gain or loss if settlement were to take place on December 31, 1996, and option contracts reflect the net liquidation cost to the Corporation if settlement were to take place on December 31, 1996. Accordingly, the estimates which follow are not necessarily indicative of the amounts that Nortel could potentially realize in a current market exchange.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Northern Telecom Limited, (millions of U.S. dollars except per share figures and unless otherwise stated)

At December 31, 1996 and 1995, the carrying amount for all financial instruments approximates fair value with the following exceptions:

	1996		1995	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial liabilities:				
Long-term debt due within one year	5	5	336	340
Long-term debt	1,663	1,689	1,221	1,271
Derivative financial instruments, net asset (liability) position:*				
Hedges of foreign investments:				
Short-term forward foreign exchange contracts	(16)	(15)	3	4
Long-term cross currency swaps	(45)	(53)	5	11
Interest rate swap agreements – short-term	—	(1)	—	(7)
Interest rate swap agreements – long-term	—	(11)	—	(17)
Contracts relating to future revenues and expenditures:				
Forward foreign exchange contracts	—	(10)	—	4
Options	—	(9)	—	—

* Trade receivable securitization balances are summarized in note 19. Long-term receivables of approximately \$268 and \$385 had also been sold, with limited recourse, as at December 31, 1996 and 1995, respectively.

Credit risk arises from the potential for counterparties to default on their contractual obligations to the Corporation. Nortel is exposed to credit risk in the event of nonperformance, but does not anticipate nonperformance by any of the counterparties. Nortel limits its credit risk by dealing with counterparties that are considered to be of high quality credits and by utilizing an internal credit committee that actively monitors the credit exposure of the Corporation. The maximum credit exposure to the Corporation is the carrying value of the financial instruments.

Nortel is also exposed to credit risk from customers and suppliers. However, Nortel's global orientation has resulted in a large number of diverse customers and suppliers, which minimizes concentrations of credit risk. Pursuant to certain financing agreements, Nortel is committed to provide future financing in connection with purchases of Nortel's products and services. These commitments totaled approximately \$2,100 and \$650 as at December 31, 1996 and 1995, respectively.

At December 31, 1996 and 1995, Nortel had outstanding guarantees of approximately \$269 and \$287, respectively, which represent bid, performance, advance payment, and financial guarantees.

24. UNUSED BANK LINES OF CREDIT

At December 31, 1996, the Corporation and certain subsidiary companies had total unused committed bank lines of credit, generally available at rates slightly above LIBOR, of approximately \$1,600.

25. COMPARATIVE FIGURES

Certain 1994 and 1995 figures in the consolidated financial statements have been reclassified to conform with the 1996 presentation.

CONSOLIDATED TEN-YEAR REVIEW

(millions of U.S. dollars except per share figures unless otherwise stated) (unaudited)

	1996	1995*
Earnings and related data		
Revenues	\$12,847	\$10,672
Cost of revenues	7,714	6,379
Selling, general, and administrative expense	2,195	1,923
Research and development expense	1,813	1,579
Depreciation on plant and equipment	439	430
Income tax provision (recovery)	321	233
Earnings (loss) before extraordinary items	623	473
Net earnings (loss) applicable to common shares	619	469
Earnings (loss) per revenue dollar (cents)	5	4
Earnings (loss) per common share (dollars)	2.40	1.85
Dividends per share (dollars)	.50	.42
Financial position at December 31		
Working capital	3,099	2,051
Plant and equipment (at cost)	4,680	4,533
Accumulated depreciation	2,645	2,610
Total assets	10,903	9,480
Long-term debt	1,663	1,221
Redeemable retractable preferred shares	—	—
Redeemable preferred shares	367	73
Common shareholders' equity	4,509	3,798
Return on common shareholders' equity	14.9%	13.1%
Capital expenditures	601	577
Employees at December 31	67,584†	63,715‡

Quarterly Financial Data

Summarized consolidated quarterly financial data for 1996 and 1995 are as follows:

Revenues
Gross profit
Net earnings
Net earnings applicable to common shares
Earnings per common share
Weighted average number of common shares outstanding (millions)

Revenues by Principal Product Lines

	1996	1995
Switching networks	\$ 4,542	\$4,231
Enterprise networks	3,865	3,245
Wireless networks	2,487	1,554
Broadband networks	1,507	1,113
Other§	446	529
Total	\$12,847	\$10,672

* Comparative amounts have been restated to conform with the current year's presentation.

† Includes Nortel's proportionate share of the employees of all joint ventures.

‡ Includes Nortel's proportionate share of the employees of Matra Communication S.A.S.

§ Includes interest income of the finance subsidiaries and prior to February 2, 1996, Cable and outside plant revenue.

1994*	1993*	1992*	1991*	1990*	1989*	1988*	1987*
\$8,874	\$8,148	\$8,409	\$8,183	\$6,769	\$6,106	\$5,408	\$4,915
5,605	5,199	4,902	4,673	4,017	3,665	3,177	2,886
1,681	1,598	1,551	1,597	1,247	1,131	1,088	938
1,156	1,040	977	968	779	733	698	573
390	426	422	435	342	319	294	264
161	(192)	274	264	220	191	104	186
408	(878)	548	515	460	377	183	347
404	(884)	536	497	436	354	166	329
5	(11)	6	6	6	6	3	7
1.60	(3.54)	2.17	2.03	1.80	1.47	.70	1.39
.36	.36	.34	.32	.30	.28	.26	.23
2,160	665	746	172	1,237	1,024	536	639
3,910	4,026	3,923	3,907	3,259	3,045	2,815	2,349
2,205	2,127	1,993	1,920	1,707	1,560	1,334	1,086
8,797	9,543	9,423	9,534	6,842	6,310	5,801	5,006
1,495	1,553	1,191	1,100	798	816	578	430
—	—	—	170	170	173	168	154
73	73	154	73	73	73	73	73
3,355	3,014	3,967	3,676	3,224	2,696	2,431	2,333
12.7%	(25.3)%	14.0%	14.4%	14.7%	13.8%	7.0%	15.6%
389	471	572	514	442	370	501	417
57,054	60,293	57,955	57,059	49,039	47,572	50,136	48,778

4th Quarter		3rd Quarter		2nd Quarter		1st Quarter	
1996	1995	1996	1995	1996	1995	1996	1995
\$4,188	\$3,496	\$3,053	\$2,487	\$3,010	\$2,442	\$2,596	\$2,247
1,749	1,421	1,177	1,013	1,180	997	1,027	862
319	250	113	81	108	80	83	62
317	249	112	80	108	79	82	61
1.23	.98	.43	.32	.42	.31	.32	.24
259	254	258	254	258	254	256	253
1994		1993*		1992*		1991*	
\$3,932		\$3,760		\$3,974		\$4,009	
2,465		2,220		2,106		1,901	
893		473		287		276	
933		753		874		850	
651		942		1,168		1,147	
\$8,874		\$8,148		\$8,409		\$8,183	

ENVIRONMENT, HEALTH, AND SAFETY PROGRESS REPORT

Nortel (Northern Telecom) is committed to protecting and enhancing the health and safety of its employees, to producing safe and environmentally responsible products, and to developing innovative solutions to environmental problems. These commitments are set out in the corporation's *Code of Business Conduct* and supported by its corporate policies.

Nortel's health and safety policy recognizes that a safe and healthy work environment contributes to continued business success through enhanced productivity and employee satisfaction. Nortel's environmental policy recognizes the critical link between a healthy environment and economic growth.

Business units are required to operate in accordance with Nortel's policies. A corporate function, led by Dr. Margaret Kerr, senior vice-president, human resources and environment, provides a framework to ensure that Nortel as an entity is meeting its compliance and social responsibilities. The corporate group establishes policy and procedures, educates line organizations as to their responsibilities, and provides guidance on systems, structures, and processes to help the line organizations effectively meet these responsibilities. Dr. Kerr reports to the executive vice-president, corporate.

This is the fourth year Nortel is reporting on its environmental progress using the PERI Guidelines¹. Health and safety reporting is included this year for the first time.

EMPLOYEE WELL-BEING

The corporate health and safety function was established in 1987. As employee health and well-being programs have matured, the emphasis has gradually shifted from reactive measures — returning sick or disabled employees to work — to a stronger focus on health promotion and preventive measures.

An ongoing health objective at Nortel is to help employees on disability return to health and to work. Over the past two years, Nortel has developed a new standardized case management protocol and customized database to assist managers in proactively supervising cases. The database also provides information on disability risks and trends.

A major health emphasis at Nortel is health enhancement or "wellness" programming. Wellness initiatives range from education programs aimed at increasing awareness regarding healthy lifestyle issues; to behavior change programs related to fitness, smoking cessation, or medical self-care; to the professional and confidential counseling provided by Employee Assistance Programs (EAP). New EAP programs were added in Taiwan and Mexico City in 1996; approximately 79 percent of Nortel employees now have access to EAP counseling. In 1996, Nortel also opened four new fitness centers, bringing the total number of centers worldwide to twenty-two. Overall, more than 55 percent of Nortel employees now have access to some form of on-site wellness program. In addition to these health enhancement activities, Nortel also conducts preventive risk-based medical surveillance.

As Nortel expands globally, increased attention is being directed to understanding health, safety, and security concerns related to doing business in new countries. Nortel has developed a process to establish overall country risk profiles using quantitative and qualitative measures, and to identify actions required to reduce risk to an acceptable level.

Minimizing safety risks also contributes to employee well-being and productivity. In addition to ensuring compliance with relevant safety standards worldwide, Nortel employs ergonomic solutions to reduce the risk of injury to employees. Nortel has focused on improving workstation design and physical work processes, and increasing ergonomics awareness.

¹ Public Environmental Reporting Initiative: a voluntary industry initiative that produced guidelines encouraging organizations to initiate and expand public environmental reporting.

ENVIRONMENT, HEALTH, AND SAFETY PROGRESS REPORT

ENVIRONMENT

The corporation is working toward taking responsibility for the environmental impacts of its products throughout their life cycles – from design to final disposition. Product life cycle work in 1996 focused on designing and building the world's first lead-free phones, and expanding the take-back of products for reuse or recycling when they are no longer of use to the customer.

Nortel's environmental management system (EMS) continues to mature. In 1996, four Nortel manufacturing sites achieved registration under ISO 14001, the international EMS standard².

In 1994, Nortel announced four environmental targets to be achieved by the year 2000. The base year for each target is 1993.

- Reduce pollutant releases (air, water, hazardous waste) by 50 percent.
- Reduce solid waste sent for disposal by 50 percent.
- Reduce paper purchases by 30 percent.
- Improve overall energy efficiency by 10 percent.

Progress toward achieving the targets is measured by monitoring year-over-year changes in aggregate, absolute figures across the entire corporation, unadjusted for growth in Nortel's sales or changes in operations. Nortel has already met the energy efficiency target and is on track to meet the paper and pollutant releases targets. Considerable improvement is required to ensure the solid waste reduction target is met.

Nortel's 1996 Environmental Performance Index score is 142³. The optimal annual score is 175. Nortel is continuing to take action to accelerate our rate of performance improvement.

The following is a summary of data from all wholly owned manufacturing and research facilities.

- Air emissions from manufacturing and research processes decreased by 19 percent in 1996 to 206 tons, from 254 tons in 1995⁴. The decrease is due in part to the sale in early 1996 of two operations that accounted for 21 percent of Nortel's emissions in 1995. The majority of Nortel's process-related emissions are alcohol-based solvents.
- Greenhouse gas emissions for 1996 were calculated using U.S. EPA emission factors for all combustion sources, and totaled 34,800 tons, a decline of 11 percent from 1995.
- Process-related water discharges decreased by 6 percent in 1996 to 97 tons, from 95 tons in 1995. Contaminants in Nortel's water discharges are mostly inorganic in nature and consist of substances such as sulfates and fluoride.
- Hazardous wastes sent for off-site management amounted to 1,120 tons in 1996, 12 percent less than the 1,280 tons reported in 1995. Of the 1996 total, 69 percent was recycled, reclaimed, or treated.

² Prepared under the direction of the International Organization for Standardization and released in 1996.

³ The EPI uses the annual cost of sales as a normalizing factor to portray performance relative to production. The EPI provides a single overall rating of the corporation's performance against its stated goals and involves measurement of twenty-five parameters, including those highlighted in this report. Each parameter is weighted according to criteria such as environmental impact and degree of risk. Each year, performance is measured against the 1993 baseline (which was assigned an EPI score of 100 points) and the previous year's performance. Any annual score greater than 100, therefore, indicates positive progress (i.e., reduced environmental impact and risk) in that year as compared to the previous year or the baseline. The 1995 EPI score was 140.

⁴ These figures include all government-reportable emissions, such as SARA Title III in the U.S. and NPRI in Canada.

ENVIRONMENT, HEALTH, AND SAFETY PROGRESS REPORT

- The amount of solid non-hazardous waste landfilled by Nortel increased 65 percent from 10,600 tons in 1995 to 17,500 tons in 1996⁵. Approximately 48 percent of all solid waste generated was recycled. In 1996, waste from construction and renovation of facilities in seven Nortel locations accounts for 22 percent of the solid waste to landfill total. Expanding product take-back initiatives at Nortel have increased volumes of equipment being processed at three Nortel Material Recycling Centers. Some of this equipment can be reused, some is recycled (58 percent in 1996), and the rest (1,440 tons in 1996) is landfilled.

- Total energy use declined by 6 percent to 2,718 billion British Thermal Units (BTU) in 1996, from 1995 levels⁶ of 2,903 billion BTU. The figure reflects electricity, natural gas, fuel oil, gasoline, and propane used for heating/cooling buildings and in manufacturing/assembly processes.

- In 1996, paper purchases decreased by 7 percent from 1995 levels to 2,150 tons.

- Water consumption in 1996 increased by 6 percent to 748 million gallons from 706 million gallons in 1995.

AUDITS AND COMPLIANCE

In addition to monitoring performance against targets, Nortel tracks progress on environment, health and safety (EHS) matters through audits conducted by external and internal auditors. Audits of manufacturing and research facilities are required to be conducted every two years. The EHS audit assesses, among other things, the locations' environmental management systems and their adherence to minimum requirements in such areas as ergonomics, accident and injury prevention, and emergency response programs, as set out in the Corporate Health and Safety Standards. This year, twenty-five sites in North America, Europe, and Asia were audited using the comprehensive EHS audit protocol.

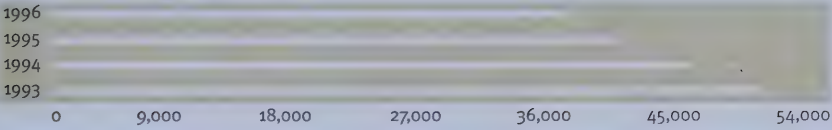
Compliance with all relevant legislation is Nortel's minimum requirement and commitment. In 1996, no fines or penalties were issued to Nortel for EHS infractions.

In 1996, remediation activities were under way at nine manufacturing locations and seven previously occupied sites. Moreover, Nortel is listed as a potentially responsible party (PRP) at six Superfund sites in the United States and is listed as a *de minimis* PRP at three of these sites. Nortel's anticipated remediation costs associated with all sites, to the extent probable and reasonably estimable, were approximately \$50 million at December 31, 1996.

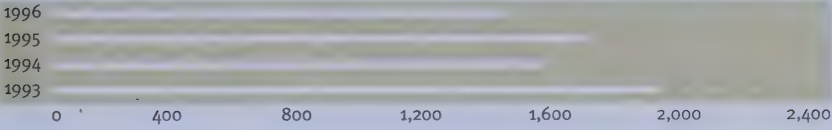
⁵ Data from five Southeast Asia manufacturing locations are included this year for the first time.

⁶ Upon further analysis of database records, the 1995 energy figure has been restated. The 1995 figure stated here is 5 percent lower than the figure reported in the 1995 Annual Report.

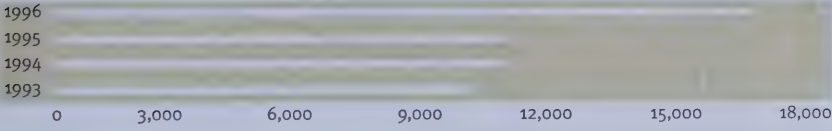
Greenhouse gases (tons/year)



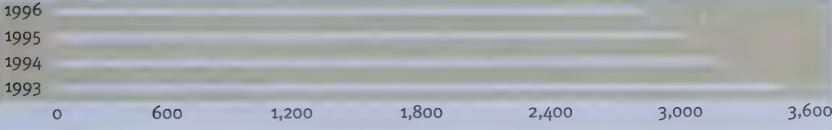
Pollutant releases: air, water, hazardous waste (tons/year)



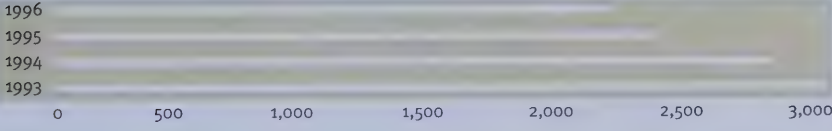
Solid waste to landfill (tons/year)



Energy consumption (billion BTUs/year)



Paper purchases (tons/year)



DIRECTORS

The board of directors, which met twelve times in 1996, is responsible for the management of the corporation's business. Directors serve on one or more of the board committees.

COMMITTEES

- 1 International Advisory
- 2 North American Advisory
- 3 Audit
- 4 Committee on Directors
- 5 Executive
- 6 Management Resources and Compensation
- 7 Pension Fund Policy
- 8 Stock Option Plan
- 9 Customer Finance
- * Chairman

DONALD J. SCHUENKE

Elm Grove, Wisconsin
Chairman of the Board
Northern Telecom Limited
Former Chairman of the Board
The Northwestern Mutual
Life Insurance Company
(life insurance company)
1,* 2,* 3,* 4, 5,* 9

JEAN C. MONTY, C.M.

Toronto, Ontario
Vice-Chairman and
Chief Executive Officer
Northern Telecom Limited
1, 2, 5

JOHN A. ROTH

Orangeville, Ontario
President and
Chief Operating Officer
Northern Telecom Limited
1, 2, 5

RALPH M. BARFORD

Toronto, Ontario
President
Valleydene Corporation Limited
(private investment company)
1, 2, 3, 4, 5, 7, 9*

FRANK C. CARLUCCI

McLean, Virginia
Chairman
The Carlyle Group
(merchant banking firm)
1, 2, 9

GERALD V. DIRVIN

Cincinnati, Ohio
Corporate Director
Former Executive Vice-President
Procter & Gamble Company
(consumer products company)
1, 2, 6, 8, 9

L. YVES FORTIER,

C.C., Q.C.
Westmount, Québec
Chairman and Senior Partner
Ogilvy Renault
(law firm)
1, 2, 3, 4, 7, 8

BOWIE K. KUHN

Ponte Vedra Beach, Florida
President
The Kent Group, Inc.
(consulting company)
1, 2, 3, 7

THE HON. E. PETER LOUGHEED, P.C., C.C., Q.C.

Calgary, Alberta
Partner
Bennett Jones Verchere
(law firm)
1, 2, 3, 8

PAUL F. OREFFICE

Lake Tahoe, Nevada
Corporate Director
Former Chairman of the Board
The Dow Chemical Company
(manufacturer of chemicals
and related products)
1, 2, 4, 6,* 8*

RONALD W. OSBORNE

Montréal, Québec
President
BCE Inc.
(telecommunications company)
1, 2, 6

SHERWOOD H. SMITH, JR.

Raleigh, North Carolina
Chairman of the Board
Carolina Power & Light Company
(electric utility company)
1, 2, 5, 7,* 9

L. R. WILSON

Montréal, Québec
Chairman and
Chief Executive Officer
BCE Inc.
(telecommunications
company)
1, 2, 4,* 5, 6

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JEAN C. MONTY, C.M.

FRANK C. CARLUCCI

RONNIE C. CHAN

Hong Kong
Chairman
Hang Lung Development
Company Limited
* Chairman

YOTARO KOBAYASHI

Tokyo, Japan
Chairman and
Chief Executive Officer
Fuji Xerox Co., Ltd.

JEAN-LUC LAGARDÈRE

Paris, France
Chief Executive Officer
Lagardère SCA

SIR ANTONY PILKINGTON

St. Helens, England
Chairman
Pilkington plc

ROBERTO SERVITJE S.

Alvaro Obregón, México
Chairman of the Board
Grupo Industrial
Bimbo, S.A. DE C.V.

OFFICERS OF THE CORPORATION

February 28, 1997

JEAN C. MONTY

Vice-Chairman and
Chief Executive Officer

JOHN A. ROTH

President and
Chief Operating Officer

CLIVE V. ALLEN

Senior Vice-President
and General Counsel

DAVID D. ARCHIBALD

Vice-President and
Deputy General Counsel

DAVID A. BALL

Senior Vice-President
and President,
Nortel Limited

JACQUES B. BÉRUBÉ

Senior Vice-President
and President,
Nortel Europe

DAVID I. BURN

Vice-President,
Taxation

CLARENCE J. CHANDRAN

Executive Vice-President
and President,
Public Carrier Networks

J. (IAN) A. CRAIG

Executive Vice-President
and President,
Broadband Networks

PETER W. CURRIE

Senior Vice-President and
Chief Financial Officer

MATTHEW J. DESCH

Executive Vice-President
and President,
Wireless Networks

GARY R. DONAHEE

Senior Vice-President
and President,
Nortel CALA

ADRIAN J. DONOGHUE

Vice-President and
Controller

FRANK A. DUNN

Vice-President,
Operations Finance
and Planning

RICHARD P. FALETTI

Executive Vice-President
and President,
Enterprise Networks

JÉRÔME P. HURET

Senior Vice-President,
Corporate Development

MARGARET G. KERR

Senior Vice-President,
Human Resources
and Environment

WILLIAM R. KERR

Vice-President
and Treasurer

ANTHONY J. LAFLEUR

Vice-President,
Associate General Counsel
and Assistant Secretary

JAMES R. LONG

Executive Vice-President
and Group Executive — Asia

ARTHUR A. MACDONALD

Senior Vice-President

DONALD S. MCCREESH

Senior Vice-President

DEBORAH J. NOBLE

Corporate Secretary and
Assistant General Counsel

KEITH I. POWELL

Senior Vice-President,
Information Systems and
Chief Information Officer

GEDAS A. SAKUS

Senior Vice-President
and President,
Nortel Technology,
and Chairman,
Bell-Northern Research Ltd.

ELLIOT S. SCHREIBER

Senior Vice-President,
Corporate Communications

C. WES M. SCOTT

Executive Vice-President,
Corporate

GEORGE C. SMYTH

Senior Vice-President
and President,
Bell-Northern Research

GORDON H. SUMNER

Vice-President and
General Auditor

DAVID J. S. WINFIELD

Senior Vice-President,
Government Relations

PHILIP H. YU

Senior Vice-President
and Chairman and
Chief Executive Officer,
Nortel China

GORDON A. DAVIES

Assistant Secretary

MICHAEL J. GOLLOGLY

Assistant Controller

KATHARINE B. STEVENSON

Assistant Treasurer

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Fax: (86-755) 669-3742

All 100 percent owned except:
Advanced Semiconductor Manufacturing
Corporation of Shanghai (34 percent)
Bell-Northern Research Ltd. (70 percent)
Guangdong Nortel Telecommunications
Switching Equipment Limited
(43 percent)
Matra Communication S.A.S.
(50 percent)
Netaş-Northern Electric
Telekomünikasyon A.S. (53 percent)
Nortel Data Network Systems GmbH
& Co. KG (50 percent)
Nortel Matra Cellular SGA (66 percent)
Nortel Post and Telecommunications
Technical Inc. (60 percent)
Shanghai Nortel Semiconductor
Corporation, Limited (70 percent)
Shenyang Nortel Telecommunications
Co., Ltd. (55 percent)
Sixel S.p.A. (49 percent)
Southern Information Systems, Inc.
(25 percent)
Tong Guang-Nortel Ltd. Liability Co.
(55 percent)

CORPORATE INFORMATION

CORPORATE HEADQUARTERS: NORTHERN TELECOM LIMITED

8200 Dixie Road
Suite 100
Brampton, Ontario
L6T 5P6 Canada
Tel: (905) 863-0000

STOCK EXCHANGE LISTINGS

The common shares of the Corporation are listed on the New York, Toronto, Montréal, Vancouver, and London stock exchanges.

ANNUAL MEETING

The annual meeting of shareholders will take place at 11:15 a.m. (local time), Thursday, May 1, 1997, at the Nortel Brampton Centre, Brampton, Ontario, Canada.

FORM 10-K

The Annual Report on Form 10-K for 1996, as filed with the United States Securities and Exchange Commission, is available without charge upon request to:
Investor Relations
Northern Telecom Limited
8200 Dixie Road
Suite 100
Brampton, Ontario
L6T 5P6 Canada

ENGLISH AND FRENCH VERSIONS

of this annual report are available upon request to:
Investor Relations
Northern Telecom Limited
8200 Dixie Road
Suite 100
Brampton, Ontario
L6T 5P6 Canada

DIVIDEND REINVESTMENT AND STOCK PURCHASE PLAN

Registered holders of common shares of the Corporation wishing to purchase additional common shares may participate in a convenient investment plan. Quarterly dividends may be reinvested automatically to purchase additional common shares at the average market price (calculated during a fixed period each quarter). Common shares may also be purchased at the average market price by voluntary cash payments of as little as US\$40 to a maximum of US\$5,000 during a quarter. In either case, there are no brokerage fees or other service charges. Additional information may be obtained from:

Dividend Reinvestment Services
Montreal Trust
Company of Canada
151 Front Street West
8th Floor
Toronto, Ontario
M5J 2N1 Canada
Tel: (416) 981-9633

TRANSFER AGENTS AND REGISTRARS

Montreal Trust
Company of Canada
Toronto, Montréal,
and Vancouver
Tel: 1-800-663-9097

The Bank of Nova Scotia
of New York Trust Company
New York, New York
Tel: (212) 225-5438

The R-M Trust Company
Ilford, Essex, England
Tel: (44-1) 81-478-1888

SHARE REPURCHASE PROGRAM

The Corporation has initiated a normal course issuer bid to repurchase common shares. This share repurchase program will enable the Corporation to buy back up to four million (approximately 1.5 percent) of its common shares (the Shares) in the period from January 30, 1997, to January 29, 1998. Shares will be bought on the Toronto and Montréal stock exchanges at market prices. Shares may be repurchased by the Corporation to offset issuances of new Shares under employee and shareholder plans in order to maintain the approximate number of Shares outstanding, or when such purchases would represent an appropriate use of corporate funds. No special arrangements will be made with particular shareholders to repurchase Shares.

A copy of the notice filed with and accepted by the Toronto and Montréal stock exchanges may be obtained, without charge, upon request to:
Investor Relations
Northern Telecom Limited
8200 Dixie Road
Suite 100
Brampton, Ontario
L6T 5P6 Canada

TRADEMARKS

The terms COMPANION, INTERNET THRUWAY, PROXIMITY, SERVICEBUILDER, NORTEL, NORTEL A WORLD OF NETWORKS, and the NORTEL corporate logo are trademarks of the Corporation.

ENTRUST is a trademark of Entrust Technologies Limited.

ON THE INTERNET

Information about Nortel is available on the Internet's World Wide Web (www) at:

<http://www.nortel.com>

COMMON SHARE DIVIDEND RECORD AND PAYMENT DATES FOR 1997*

Record Date	Deadline for Receipt of Optional Cash Payments	Payment Date/ Investment Date
March 17	March 27	March 31
June 6	June 27	June 30
September 5	September 29	September 30
December 5	December 30	December 31

* Subject to approval of the Board of Directors



Consistent with our commitment to the protection and enhancement of the environment, the paper used in this document contains 15 percent post-consumer waste.

